Supreme Court, U.S.
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No. OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

THE DOW CHEMICAL COMPANY AND SUBSIDIARIES,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Taxpayers must satisfy the judicially crafted economic substance doctrine in order to invoke the specific provisions of the Internal Revenue Code. Under this fact intensive doctrine, taxpayers may not obtain any federal tax benefits from transactions that have no appreciable economic effect apart from tax savings. The trial court in this case upheld the economic substance of petitioner's transactions and the claimed tax deductions based on the court's finding that petitioner would make cash investments in later years consistent with its long-term business needs and financial incentives. On appeal, a divided panel of the Sixth Circuit reversed, holding that the trial court's determination on economic substance is subject to *de novo* review and that future taxpayer investment must be disregarded as a matter of law if it "departs drastically" from the taxpayer's prior conduct during the course of the transaction. The questions presented are:

1. Whether the Sixth Circuit erred by holding, in direct conflict with at least five circuits (but in accord with at least two others), that the trial court's determination on economic substance is subject to *de novo* review.

2. Whether the Sixth Circuit erred by creating, in direct conflict with decisions of this Court and other circuits, an exclusionary rule for economic substance cases that bars consideration of future taxpayer investment merely because the taxpayer has engaged in a long-term transaction in which a substantial portion of its out-of-pocket expenditure is deferred.

RULE 29.6 STATEMENT

The Dow Chemical Company has no parent corporation, and there is no publicly held company owning 10% or more of its stock. It is the parent of the subsidiaries included within the consolidated group for tax purposes as of the date of this petition, and no other publicly held company owns 10% or more of the stock of any of those subsidiaries. Subsidiaries that were members of the consolidated group for tax purposes during the tax years at issue, but are no longer included in The Dow Chemical Company's consolidated tax group, are not financially interested in the outcome of this litigation.

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JURISDICTION

The Sixth Circuit entered judgment on January 23, 2006, and denied the petition for rehearing on May 24, 2006. Justice Stevens extended the time to file this certiorari petition to and including October 6, 2006. App. No. 06A86. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant provisions of 26 U.S.C. §§ 162, 163, and 264 are reproduced at Appendix 209a - 212a. Unless otherwise indicated, this petition refers to the provisions of Title 26 as in effect during tax years 1989-91.

STATEMENT OF THE CASE

1. **Introduction.** The Dow Chemical Company ("Dow") is a diversified chemical company based in Midland, Michigan, that files a consolidated federal income tax return. During tax years 1989-1991, Dow deducted about $33 million consisting of both administrative fees and policy loan interest related to corporate-owned whole life insurance ("COLI") plans. The Internal Revenue Service ("IRS") contended that Dow's COLI plans lacked economic substance and hence disallowed the deductions, resulting in an assessment of income tax deficiencies and interest thereon totaling over $22 million. Dow paid this amount and filed this refund action in federal district court to recover that amount plus interest.

Following a two-month bench trial in which 26 witnesses testified and over 1,500 exhibits were received, the district court filed a 139-page opinion (as well as a 15-page post-

judgment decision) rejecting the IRS's economic substance arguments and sustaining Dow's right to the deductions. The district court succinctly described the issue before it as "whether the deductions would be enhancing the benefit of an already economically viable set of transactions." App. 202a. The court answered "yes" because it found that Dow intended from the outset to invest substantial cash in its COLI plans over time, consistently with its business needs and the economic incentives of the plans.

The government appealed, claiming principally that the district court's finding that Dow would make such future investments was clearly erroneous. A divided panel of the U.S. Court of Appeals for the Sixth Circuit left this and all other findings by the district court undisturbed, but nevertheless reversed. It relied on a *de novo* standard of review to assess the trial court's ultimate determination on economic substance, and crafted *sua sponte* an exclusionary rule that the majority held to be dictated by a footnote in this Court's decision in *Knetsch v. United States*, 364 U.S. 361 (1960). According to the majority, *Knetsch* requires courts in determining economic substance to ignore a future investment by the taxpayer that "drastically" exceeds the taxpayer's prior cash expenditures, even if the investment is a crucial part of the taxpayer's plan in undertaking the transaction and is consistent with its business needs and financial incentives. The majority applied this formulaic rule to bar consideration, as a matter of law, of the trial court's finding regarding Dow's intended cash investments, thereby allowing the majority to conclude that Dow's COLI policies lacked economic substance. Disagreeing "with the legal principles my colleagues invent and mistakenly attribute to *Knetsch*," the third member of the Sixth Circuit panel dissented. App. 21a. The dissent took issue with the majority's exclusionary rule, concluding that "there is no such precedential rule of law and no warrant for creating one in this case." *Id.*

A grant of certiorari is warranted to (i) resolve the conflict among the circuits over the proper standard of review for trial court determinations of economic substance and (ii) correct the Sixth Circuit's distortion of *Knetsch* and other conflicts with decisions of this Court.

2. **COLI, the Tax Code, and the Economic Substance Doctrine.** COLI policies are long-term whole life insurance plans purchased by a corporate employer to insure the life of one or more of its employees. The employer ordinarily owns the policy, pays the premiums, and is the policy beneficiary. A portion of the premium that the employer pays exceeds the mortality and other policy costs of insuring the employee's life and represents a financial investment. This investment earns a return from the insurance company, which compounds over time creating "inside buildup." The employer's investment and inside buildup (together, the "cash value" of the policy) is paid out to the employer in cash as a death benefit when the insured employee dies.

Corporate policy owners, like other holders of whole life policies, are entitled to access the cash value during the term of the policy through (1) policy loans and (2) partial withdrawals. First, employers may take out loans from the insurance company, using the policy's cash value as security. If an insured employee dies while a policy loan is outstanding, the insurance company uses the death benefit first to repay the loan and accrued interest and disburses only the balance to the employer. Policy loans come with a price, however, as the insurance company charges interest at a rate greater than the inside buildup rate it pays. Second, policy owners can withdraw funds from the policy's cash value that do not secure policy loans. The policy owner has no obligation or right to repay such partial withdrawals.

To the extent that cash value does not secure policy loans and is not withdrawn, a COLI policy, like other whole life insurance, creates "net cash value" (also known as "net equity"), which through the compounding of interest can

accumulate to a large sum over the life of each insured. This net cash value generates significant cash flow when eventually paid out as death benefits, yielding a healthy return for the employer. COLI plans thus customarily constitute long-term investments.

Beyond the financial benefits of life insurance, Congress has long treated life insurance favorably for federal income tax purposes. Inside build-up is tax-deferred and generally is wholly exempt from tax if paid out in the form of a death benefit. Partial withdrawals of cash value also are tax-free up to "basis" – *i.e.*, up to the amount of the policy holder's investment in the policy, not including inside buildup. *See* 26 U.S.C. §§ 72, 101(a). Importantly, interest paid by policy holders on policy loans has long been deductible under 26 U.S.C. § 163(a). Congress, however, has limited these loan interest deductions over the years; with respect to COLI, for example, it began in 1986 to allow deductions only on loans of $50,000 per employee or less, and in 1996 it phased out deductions on loans under post-1986 contracts involving more than a limited number of key corporate officers or 20-percent corporate owners. *See id.* §§ 264(a)(4) and (e) (2006); Health Insurance Portability and Accountability Act of 1996, Pub. L. 104-191, § 501, 110 Stat. 1936, 2090 (1996); Tax Reform Act of 1986, Pub. L. 99-514, § 1003, 100 Stat. 2085, 2388 (1986).

In addition to compliance with the literal terms of the Internal Revenue Code, the courts have required that transactions have "economic substance" to entitle the taxpayer to interest and other deductions. *See, e.g.*, *Knetsch*, 364 U.S. at 367. This overarching doctrine, which requires a close examination of the relevant facts and circumstances, serves as a hurdle that *every* transaction must surmount to qualify for benefits under the tax laws. *See Lerman v. Comm'r*, 939 F.2d 44, 52 (3d Cir. 1991), *cert. denied*, 502 U.S. 984 (1991) ("Per *Gregory v. Helvering*, 293 U.S. 465 (1935), it is settled federal tax law that for transactions to be

recognized for tax purposes they must have economic substance. Therefore, economic substance is a *prerequisite* to the application of any Code provisions allowing deductions").

The correct legal test for economic substance is not disputed in this case. That test is whether the transaction "appreciably" affects the taxpayer's "beneficial interest except to reduce his tax." *Knetsch*, 364 U.S. at 366 (internal quotation marks omitted); *see also*, *e.g.*, App. 8a (the issue is "whether the transaction has any practicable economic effects other than the creation of income tax losses") (internal quotation marks omitted). Whether the transaction absent tax deductions yields a profit is generally a key factor in making this determination. *See, e.g.*, 364 U.S. at 366.

3. **Dow's COLI Plans.** One use of COLI that has been recognized in guidelines issued by the National Association of Insurance Commissioners, the Office of the Comptroller of the Currency, and the State of Michigan is to fund employee benefit programs. *See* App. 223a, 227a, 260a. As found by the district court below, in 1988 and 1991, Dow purchased COLI plans covering about 4,000 and 17,000 consenting employees from Great West Life Assurance Company ("Great West") and Metropolitan Life Insurance Company ("MetLife"), respectively, for precisely this purpose. App. 36a, 60a-61a, 70a, 100a-101a. The expected costs of the medical benefits Dow was providing its retirees had grown rapidly over time to a net present value of over $1 billion by 1987, and Dow's executives had become concerned that the company might be unable to continue to offer such benefits unless it found a way to fund the escalating expenses. App. 61a. Dow responded to the problem by forming task forces and hiring an outside actuarial consultant to study COLI as a possible solution. App. 61a, 65a, 95a. Ultimately, following task force recommendations, Dow's Board of Directors approved the Great West and MetLife purchases. App. 80a-81a, 99a-100a.

Dow's plan from the outset in acquiring its COLI policies had two phases. First, it would reduce (but by no means eliminate) initial out-of-pocket expenditures by financing premium payments and other policy costs through (a) policy loans up to $50,000 per insured and (b) withdrawals of cash value up to basis.[1] Thereafter, Dow would pay policy costs with its own cash rather than through further financing. Over time, this plan would generate net cash value resulting in substantial cash flow from death benefits to help fund Dow's retiree medical costs. App. 132a-134a, 144a, 148a-149a, 150a. For example, in purchasing the MetLife policy, Dow intended to rely on loans and withdrawals during the first 18 years of a 60-year policy, as shown in a financial projection called "Case 23." Dow would then pay policy costs with its own cash. The resulting net cash value would create substantial inside buildup, producing an aggregate "pre-tax" cash flow (*i.e.*, cash flow without considering the benefit of the interest deductions on the policy loans) of $3.6 billion over the 60-year term. App. 97a-99a, 147a-149a, 150a. This cash flow had a positive pre-tax net present value at valid discount rates under the discounting methods employed by both Dow's and the government's experts. App. 149a-150a; *see also* App. 201a-203a.

As planned, Dow took out policy loans and deducted interest and COLI administrative fees on its 1989-1991 income tax returns. The IRS disallowed the deductions, contending that Dow's policies lacked economic substance

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[1] In financing policy costs with loans and withdrawals, Dow engaged in essentially simultaneous netting transactions under which it paid the insurance company the difference between the amount of costs due and the amount of the loan or withdrawal taken. The government argued (1) that these transactions were shams in fact (*i.e.*, that they did not actually occur) and (2) that they disqualified Dow's interest deductions under 26 U.S.C. § 264. The district court rejected both claims (App. 192a-199a, *modifying* App. 153a-161a, 166a-168a), and the government abandoned them on appeal. *See* App. 7a n.7.

because Dow never intended to make the future cash investments and thus would never build net cash value and earn positive pre-tax cash flow. App. 118a-119a, 130a.

4. **The District Court Decision.** The trial court (Lawson, J.), which had jurisdiction over Dow's refund action under 28 U.S.C. § 1346(a), began its decision by distinguishing this case from prior COLI cases where the courts had found that the COLI plans were devoid of economic substance, "functioning only as interest-deduction engines that drove no legitimate financial vehicles." App. 45a-58a (quotation at 57a). *See American Electric Power Co. v. Comm'r*, 326 F.3d 737 (6th Cir. 2003), *cert. denied*, 540 U.S. 1104 (2004) ("*AEP*"); *In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002); *Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, 535 U.S. 986 (2002). That conclusion stemmed in part from the fact that the taxpayers there had agreed to pay an "artificially high" interest rate on policy loans – *i.e.*, a rate substantially in excess of the industry standard and regulatorily approved Moody's Corporate Average. This magnified the interest deductions and hence greatly reduced taxable income, but had "no practical adverse effect on the borrower" because the rate that the insurer credited to cash value securing the loans was ratcheted up by the same artificial amount. App. 57a, 59a-60a, 155a-157a. At the same time, the insurers undertook to credit only a "relatively small" rate on cash value in excess of the loan balance, which "discourage[d] [the taxpayers from] leaving cash in the policies." App. 57a. As the pre-purchase projections and marketing information in those cases confirmed, there consequently "could be . . . no return on inside build-up because all the cash was stripped from the policies *throughout the program*." App. 57a (emphasis added); App. 153a. In essence, the taxpayers had taken such extreme advantage of the tax benefits offered by COLI that they had emptied their programs of any non-tax economic significance.

The trial court found that there were "critical differences" between Dow's policies and those in the prior cases. App. 58a. Most importantly, resolving "a principal factual dispute," the court found that, unlike the other taxpayers, Dow specifically intended in acquiring its policies to build significant net cash value. App. 133a-134a. In making this finding, the court relied on the following evidence: (1) the "accurate and truthful" testimony by former Dow employees and non-company witnesses knowledgeable about its plans "that it was Dow's intention to cap loans at $50,000 and withdraw only to basis," and then "inject cash . . . in the middle years" (App. 133a-134a; *see also*, *e.g.*, App. 148a-149a); (2) contemporaneous documentary evidence corroborating Dow's intent to create net cash value, including written pre-acquisition recommendations and projections like MetLife Case 23 (App. 134a, 148a-150a); (3) the fact that capping loans at $50,000 per insured was "more consistent" than permanently stripping net cash from the policies "with Dow's stated purpose of embarking on this project at the outset," as it "produce[d] higher positive cash flow to fund retiree medical costs" and "yielded more favorable financial performance" in the future (App. 134a; *see also*, *e.g.*, App. 148a-149a); and (4) Dow's insistence on limiting its policy loan interest rates to Moody's Corporate Average (App. 67a, 107a), while negotiating *high* crediting rates on unborrowed net cash value (App. 77a, 148a-149a). This combination of rates "did not financially 'compel' borrowing . . . as existed in the other COLI cases." App. 134a. Instead, the high crediting rates on net cash value encouraged Dow to invest cash by "provid[ing] a substantial return, especially considering that the inside build-up occurs tax free." App. 150a.[2]

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[2] Still other evidence supported the court's critical finding on Dow's intended plan of operation. *See*, *e.g.*, App. 134a, 149a (by limiting loans and withdrawals, Dow avoided paying (1) non-deductible interest and (2)

Given Dow's intent and incentives to operate the plans as a whole to generate large cash flows from net cash value, the trial court had no trouble "find[ing] that Dow ha[d] established by a preponderance of the evidence that both its Great West and MetLife COLI plans ... had substantial [non-tax] effects on the beneficial interest of the taxpayer" and so "were imbued with economic substance." App. 153a.

5. **The Panel Majority Decision.** On appeal to the Sixth Circuit, a divided panel (Moore and Cook, JJ.) reversed. In rulings that apply broadly to economic substance disputes, the majority first held that, although "there may appear to be some tension" in the Sixth Circuit's own case law, the standard of review for the ultimate determination on economic substance is *de novo*.[3] App. 9a & n.8. Then, expressly declining the government's invitation to reverse as clearly erroneous the trial court's finding that Dow intended to invest substantial cash in the policies, the majority *sua sponte* imposed a rule excluding, as a matter of law, any consideration of that finding. App. 9a-15a. With the planned investments disregarded, the majority concluded that Dow's COLI policies would enjoy little or no inside buildup, produce no positive pre-tax cash flow, and thus have no economic substance. App. 13a-16a.

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tax on withdrawals above basis); App. 96a, 147a (Dow's status as Alternative Minimum Taxpayer at time of MetLife purchase underscored that it was "examining the prospect of generating cash through the COLI plan after the acquisition phase of the policy and viewed the performance of the plan over its whole life"); App. 115a-18a (Dow retained its policies after Congress phased out the interest deduction for large-scale COLI).

[3] The majority stated that both parties agreed to the *de novo* standard. But, in fact, Dow argued against *de novo* review (*see* App. 214a n.15), and the majority addressed those arguments (App. 9a n.8). Dow accepted *de novo* review only on the condition that the "ultimate determination follows directly from affirmance or reversal of *the trial court's finding on Dow's capped-loan intent*" (App. 214a (emphasis added); *see also* App. 218a n.1) – a condition that the majority vitiated by adopting a novel rule excluding that factual finding.

The majority based its exclusionary rule on a brief footnote in this Court's decision in *Knetsch*, 364 U.S. at 366 n.3. The majority asserted that this footnote dictates that "[c]ourts may consider future profits contingent on some future taxpayer action, *but only when that action is consistent with the taxpayer's actual past conduct*." App. 13a (emphasis added). The majority further held that courts should not even attempt to assess the likelihood that the future action will actually occur by taking into account whether it was part of the taxpayer's initial plans or how profitable it would be to the taxpayer. Instead, "the better course is to remain true to *Knetsch* by limiting the inquiry to whether the future investment drastically departs from past conduct." App. 14a n.13.

Rather than remand to the district court, the majority applied the exclusionary rule itself. It first noted that Dow paid in cash out of its own pocket $59.7 million to Great West from 1988 to 2000 and $83.8 million to MetLife from 1991 to 1998. App. 5a. It then calculated that Dow would have to pay in cash in the middle years an additional $30 million to Great West and $285 million to MetLife "to make the COLI plans profitable." App. 10a n.9. "On these facts," the majority concluded, the exclusionary rule applied because there could "be no doubt that the projected cash infusions would have required Dow to depart drastically from its past conduct." App. 14a n.13. The majority stated that it would be permissible to take account of a contractual commitment "to infuse additional cash into an investment at some point in the future" because, in its view, "the eventual outlay would [then] be consistent with actual past conduct." But Dow was under no such contractual requirement in this case. App. 15a n.14.

In sum, the majority held that, despite the trial court's factual finding that Dow would invest large amounts of cash in the policies in future years, "the teachings of *Knetsch*" precluded consideration of that finding regardless of the

evidence supporting it. App. 14a-15a. Dow's COLI policies then would forever have little or no net cash value and negative pre-tax cash flow, allowing the majority to conclude that the policies lacked economic substance. App. 15a-16a.[4]

6. **The Dissent.** Disagreeing "with the legal principles my colleagues invent and mistakenly attribute to *Knetsch*," the third member of the panel (Ryan, J.) dissented. App. 21a. He took issue with the majority's exclusionary rule, concluding that "there is no such precedential rule of law and no warrant for creating one in this case." *Id.* In his view, this Court in *Knetsch* "did not hold that, as a matter of law, a feasible projected future investment of cash in a particular plan is irrelevant to the economic substance inquiry"; rather, "[t]he question is what the taxpayer intended." App. 22a. Once Dow's "potential future cash flows are not arbitrarily excluded from the economic substance inquiry," he continued, the "case turns on the district court's findings of fact regarding the intended operation of Dow's COLI plans." *Id.* And, as to that, the trial court's findings of fact were not clearly erroneous. App. 21a, 23a.

7. **Dow's Rehearing Petition.** Because the majority's exclusionary rule transformed a routine challenge to the district court's findings into a major economic substance decision, Dow sought rehearing. The majority denied the petition. App. 206a. Judge Ryan would have granted the petition for the reasons stated in his dissent. *Id.*

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[4] "The presence of risk transfer and the possibility of a mortality profit on a plan-wide basis" also provided "one of the grounds" for the district court's decision. App. 200a-201a (emphasis omitted). Although the majority overturned this finding too (App. 17a-20a), the trial court's finding regarding Dow's intent to build net cash value would establish economic substance by itself if this Court were to decide that it cannot be disregarded. *See AEP*, 326 F.3d at 742 (policies devoid of economic substance because taxpayer could not benefit from "either" inside buildup or mortality gain); App. 22a-23a (dissenting opinion below).

REASONS FOR GRANTING THE PETITION

This petition raises two related questions meriting this Court's review. First, the *de novo* standard adopted by the Sixth Circuit to review the district court's determination on economic substance was critical to the judgment below, directly conflicts with the clearly erroneous test followed in most circuits, and presents an important question because the standard of review provides the framework for every appeal involving the economic substance doctrine. This Court over the years has developed principles for resolving issues exactly like this, but remarkably, with few exceptions, the lower courts, including the Sixth Circuit, have failed even to consult them. If the Court were to resolve the circuit split by applying its standard of review jurisprudence here, it would reverse the decision below.

Second, the exclusionary rule adopted by the Sixth Circuit on the merits turns this Court's decision in *Knetsch* on its head, directly conflicts with this Court's contrary ruling in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), disregards this Court's teachings in *Comm'r v. Duberstein*, 363 U.S. 278 (1960), and contradicts the decisions of other circuits that sensibly rely on the taxpayer's intent and economic incentives in evaluating economic substance. Because the root of the error below lies in misuse of this Court's decisions, this Court should correct the error. Moreover, the rule imposed below is plainly wrong and, unless overturned, will confound future development of the economic substance doctrine, a fundamental and frequently recurring issue especially in tax cases of large economic importance.[5] Contrary to Congressional intent, it also will

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[5] According to our count, from 1995 to the present, the government has challenged transactions on economic substance grounds in over 170 decided court cases involving over $4.4 billion in taxable income. Since 2000, the appellate courts have been particularly active in this area, handing down decisions involving over $2.7 billion. These dollar amounts may be significantly understated because adequate information

threaten deductions in long-term financing and other commonplace business transactions.

I. THE SIXTH CIRCUIT'S APPLICATION OF THE *DE NOVO* STANDARD OF REVIEW CONFLICTS WITH DECISIONS OF OTHER CIRCUITS

The government argued below that the trial court's finding on Dow's intent to make future cash investments in its COLI plans was clearly erroneous. Rather than pass on this claim, the majority held that the trial court's "ultimate conclusion" on economic substance is subject to *de novo* review. App. 9a & n.8, 11a. That ruling was critical to the Sixth Circuit's judgment because it enabled the majority to forego clear error review of the trial court's finding and instead address whether the positive cash flow due to Dow's planned cash infusions was "relevant *as a matter of law* to the economic-sham analysis." App. 11a (emphasis added).[6] The majority's adoption of the *de novo* standard warrants this Court's review because (1) the circuits are deeply divided on the issue, (2) the debate in the lower courts largely ignores this Court's standard of review jurisprudence, which strongly supports the clearly erroneous standard, and (3) the standard of review sets the stage for consideration of every appeal involving economic substance issues.

1. The courts of appeals are in sharp conflict regarding the correct standard of review of the ultimate determination

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is not readily available for all relevant cases. The figures, moreover, do not take account of economic substance controversies settled before trial.

[6] Had the Sixth Circuit applied the clearly erroneous standard to the district court's ultimate determination of economic substance, it would have been required to affirm the trial court's well substantiated finding that Dow's COLI plans had economic substance because the plans would generate substantial net cash value and positive pre-tax cash flow and because there was no dispute that appreciable non-tax economic effects establish economic substance.

of economic substance. In 1990, for example, recognizing the split, the Tenth Circuit held that "the ultimate characterization of the transactions as shams" should be reviewed *de novo* even though a number of other "circuits treat sham determinations as questions of fact." *James v. Comm'r*, 899 F.2d 905, 909 & n.5 (10th Cir. 1990). Today, the circuits are divided with at least five supporting deferential review and three supporting *de novo* review. In particular, the Second, Third, Fourth, Seventh, and D.C. Circuits adhere to the clearly erroneous standard.[7] By contrast, in addition to the Sixth Circuit, the Tenth and Federal Circuits have adopted the *de novo* standard.[8] In some circuits, the test is impossible to ascertain due to the

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[7] *See, e.g., Nicole Rose Corp. v. Comm'r*, 320 F.3d 282, 284 (2d Cir. 2002) ("Whether a transaction lacks economic substance is a question of fact that we review under the clearly erroneous standard."); *ACM P'ship v. Comm'r*, 157 F.3d 231, 245 & n.25 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999) ("[W]e review [the Tax Court's] factual findings, including its ultimate finding as to the economic substance of a transaction, for clear error."); *Black & Decker Corp. v. United States*, 436 F.3d 431, 441 (4th Cir. 2006), *following Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 92 (4th Cir. 1985) ("Whether . . . a particular transaction is a sham is an issue of fact, and our review of the tax court's subsidiary and ultimate findings on this factual issue is therefore under the clearly erroneous standard."); *Yosha v. Comm'r*, 861 F.2d 494, 499 (7th Cir. 1988) ("The question whether a particular transaction has economic substance, like other questions concerning the application of a legal standard to transactions or events, is governed by the clearly erroneous standard."); *ASA Investerings P'ship v. Comm'r*, 201 F.3d 505, 511 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000) (stating that in sham partnership cases "mixed questions of law and fact are to be treated like questions of fact").

[8] *See, e.g., James*, 899 F.2d at 909 & n.5 ("[W]e review de novo the ultimate characterization of the transactions as shams."); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1357 (Fed. Cir. 2006) (explaining that, in an economic substance dispute, "[t]he ultimate conclusion as to business purpose is a legal conclusion, which we review without deference").

proliferation of conflicting authorities.[9]

For the most part, the circuit court decisions have engaged in rote recital of conclusory language from earlier opinions, with little analysis. Moreover, in some circuits, including the court below, the precedents have evolved like a

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[9] *Compare, e.g., Gulig v. Comm'r*, 293 F.3d 279, 281 (5th Cir. 2002) (stating that sham partnership determination reviewed "for clear error"), *and Lukens v. Comm'r*, 945 F.2d 92, 97 (5th Cir. 1991) ("The tax court's determination that the transaction was a 'sham' is a finding of fact, and therefore reviewable under the clearly erroneous standard."), *with, e.g., Compaq Computer Corp. v. Comm'r*, 277 F.3d 778, 780-81 (5th Cir. 2001) ("'[L]egal conclusions' that transactions are shams in substance are reviewed de novo."). *Compare Massengill v. Comm'r*, 876 F.2d 616, 619 (8th Cir. 1989) (characterizing economic substance inquiry as "essentially factual," subject to clearly erroneous review), *with, e.g., IES Indus., Inc. v. United States*, 253 F.3d 350, 351 (8th Cir. 2001) (characterizing economic substance of transaction for tax purposes as question of law).

Compare, e.g., Harbor Bancorp v. Comm'r, 115 F.3d 722, 727 (9th Cir. 1997), *cert. denied*, 522 U.S. 1108 (1998) ("[T]he Tax Court's [sham] determination . . . is a finding of fact we review for clear error."), *Erhard v. Comm'r*, 46 F.3d 1470, 1476 & n.7 (9th Cir. 1995), *cert. denied*, 516 U.S. 930 (1995) ("The tax court's determination that a transaction is lacking in economic substance is a factual determination that this court reviews for clear error."), *and Casebeer v. Comm'r*, 909 F.2d 1360, 1362 & n.6 (9th Cir. 1990) ("We review the tax court's ultimate conclusion that the transactions were shams for clear error."), *with Sacks v. Comm'r*, 69 F.3d 982, 986 (9th Cir. 1995) (stating that, in economic substance cases, "application of the legal standards to the facts found [is] reviewed *de novo*.").

Finally, *compare Karr v. Comm'r*, 924 F.2d 1018, 1023 (11th Cir. 1991), *cert. denied*, 502 U.S. 1082 (1992) ("[T]he Tax Court's finding that a transaction is a sham is normally subject to the clearly erroneous standard of review."), *with United Parcel Service of America, Inc. v. Comm'r*, 254 F.3d 1014, 1017 (11th Cir. 2001) ("The question of the effect of a transaction on tax liability, to the extent it does not concern the accuracy of the tax court's fact-finding, is subject to de novo review."), *and Kirchman v. Comm'r*, 862 F.2d 1486, 1490 (11th Cir. 1989) (stating that, in the case of transactions held by Tax Court to be shams as a matter of law, standard of review is *de novo*).

game of judicial hopscotch in which, notwithstanding the doctrine of *stare decisis*, the appellate court jumps freely from one standard of review to another. *Compare* the decision below (App. 9a & n.8), *AEP*, 326 F.3d at 741-42, *and Smith v. Comm'r*, 937 F.2d 1089, 1096 (6th Cir. 1991), *with Rink v. Comm'r*, 47 F.3d 168, 173 (6th Cir. 1995), *Kennedy v. Comm'r*, 876 F.2d 1251, 1255 (6th Cir. 1989), *and Ratliff v. Comm'r*, 865 F.2d 97, 98-99 (6th Cir. 1989). *See also* note 9 above.

2. At the same time, in an increasingly long line of opinions in other areas of the law, this Court has developed a principled jurisprudence for settling standard of review questions. This jurisprudence, generally ignored by the circuit courts in reviewing economic substance determinations, firmly supports application of the clearly erroneous standard here.

As this Court has explained, the "standard of deference for appellate review of district court determinations [should] reflect an accommodation of the respective institutional advantages of trial and appellate courts." *Salve Regina College v. Russell*, 499 U.S. 225, 233 (1991) (review of state law determination under *Erie*). Accordingly, *de novo* review may be favored where appellate courts can "identify[] recurrent patterns, and advanc[e] uniform outcomes." *Thompson v. Keohane*, 516 U.S. 99, 114 (1995) (review of "in custody" determination under *Miranda*). This is especially true where overriding constitutional interests are at stake, as in determinations of "actual malice" in defamation suits, *see Bose Corp. v. Consumers Union of United States, Inc.*, 466 U.S. 485 (1984), or of reasonable suspicion to stop and probable cause to search, *see Ornelas v. United States*, 517 U.S. 690 (1996).

On the other hand, deferential review is appropriate for situations in which "factual nuance may closely guide the legal decision," *Buford v. United States*, 532 U.S. 59, 65 (2001) (review of "consolidation" determination under U.S.

Sentencing Guidelines), or in which *de novo* review will "fail to produce the normal law-clarifying benefits that come from an appellate decision on a question of law," as when "'multifarious, fleeting, special, narrow facts . . . utterly resist generalization . . . .'" *Pierce v. Underwood*, 487 U.S. 552, 561-62 (1988) (review of "substantial justification" under Equal Access to Justice Act); *see also Cooter & Gell v. Hartmarx Corp.*, 496 U.S. 384, 404 (1990) (review of Fed. R. Civ. P. 11 determinations).

"Treating issues of intent," for example, "as factual matters for the trier of fact [subject to deferential review] is commonplace" and required even when the finding is an "ultimate fact" dispositive of the case. *Pullman-Standard v. Swint*, 456 U.S. 273, 286, 288 (1982) (review of discriminatory purpose determination under Title VII); *see also Hernandez v. New York*, 500 U.S. 352 (1991) (review of discriminatory intent determination under *Batson*); *Duberstein*, 363 U.S. at 290-92 (review of donative intent for "gift" determination under Internal Revenue Code). This, of course, is because of "the unique opportunity afforded the trial court judge to evaluate the credibility of witnesses and to weigh the evidence." *Inwood Labs., Inc. v. Ives Labs., Inc.*, 456 U.S. 844, 855 (1982) (review of mislabeling determination under Trademark Act); *see also Bose Corp.*, 466 U.S. at 516 (deference "tends to increase when trial judges have lived with the controversy for weeks or months instead of just a few hours").

This Court has yet to apply these principles to the standard of review issue presented here. In *Frank Lyon*, 435 U.S. at 581 n.16, the Court stated that "[t]he general characterization of a transaction for tax purposes is a question of law subject to review." But this statement did not squarely address the proper standard of review for the determination whether a transaction has economic substance, and has failed to bring uniformity in the lower courts to the review of such determinations. *See* notes 7-9 above.

Moreover, it largely preceded development of the Court's standard of review jurisprudence, which argues strongly for clear error review of the ultimate finding on economic substance. As the Seventh Circuit observed in considering whether the taxpayer made bona fide sales of surplus inventory in *Rexnord, Inc. v. United States*, 940 F.2d 1094, 1096-97 (7th Cir. 1991), the dispute "seems to raise predominately factual questions" over which "[t]here is no reason to conclude that" appellate judges "are in a better position to weigh the relative significance of specific facts and assess the total character of" the matter "than the district court." Moreover, "[c]onsiderations which favor a de novo standard, such as the desire to create a uniform rule, are not present here since no single rule could embrace the varied fact patterns which may arise . . . ." *Id.* at 1097; *see also Thompson v. Comm'r*, 631 F.2d 642, 646 (9th Cir. 1980), *cert. denied*, 452 U.S. 961 (1981).[10]

3. The standard of review, on which the circuits are split, establishes the fundamental framework for consideration of every economic substance issue and thus significantly colors every appeal in this area. *See* Fed. R. App. P. 28(a)(9)(B) and (b)(5) (briefs must state standard of review for each question presented); *see also* Fed. R. App. P. 28, Advisory

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[10] The *Thompson* court explained: "[W]e find that the Tax Court's determination whether a transaction is lacking in economic substance is essentially a factual determination, and therefore, subject to the clearly erroneous standard of review. *Weisbart v. Commissioner*, 564 F.2d 34, 36 (10th Cir. 1978). This is because the Tax Court's inquiry is not directed toward the application of a statute or an express legal standard. Instead, it requires the Tax Court to focus on the facts and circumstances of particular transactions and resolve whether, as a practical matter, those transactions have any economic impact outside the creation of tax deductions. Enmeshed as it is in factual considerations, the conclusion reached by the Tax Court will spring more from its experience 'with the mainsprings of human conduct' rather than the application of any legalistic formula, and makes appropriate a narrow standard of review. *See Commissioner v. Duberstein*, 363 U.S. 278, 289-91 (1960)."

Comm. Notes, 1993 Amendments ("[R]equiring a statement of the standard of review generally results in arguments that are properly shaped in light of the standard."). In addition, the outcome of the case often turns on the standard of review, as it did here. Hence, the circuit split is important and warrants this Court's review.

II. THE SIXTH CIRCUIT'S EXCLUSIONARY RULE CONFLICTS WITH DECISIONS OF THIS COURT AND OTHER CIRCUITS

A. The Majority's Decision Conflicts With Supreme Court Precedents

1. The panel majority's exclusionary rule is flatly inconsistent with this Court's precedents. The majority incorrectly grounded the rule entirely on *Knetsch*. According to the majority, the Court held there that, in any economic substance inquiry, investment by the taxpayer that somehow departs from the taxpayer's actual prior conduct is irrelevant as a matter of law even if the evidence shows that that investment in fact will be made and, indeed, is the only prudent economic course. But *Knetsch* held no such thing. Instead, *Knetsch* stands for the proposition that the future profitability of the taxpayer's transaction *is* legally relevant to the economic substance inquiry, and therefore future investment affecting profitability must be taken into account unless the taxpayer has no intention of making it. By disregarding Dow's planned investments without such evidence, the majority excluded from consideration a relevant – indeed, crucial – step in Dow's transactions in direct conflict with *Knetsch*.

Knetsch purchased annuity savings bonds with an initial face value of $4,004,000, using $4,000 cash and a $4 million loan, on which he was not personally liable, secured by the bonds. At their maturity in 30 years, the bonds would generate a monthly annuity in an amount of more than $90,000 if Knetsch did not borrow against the bonds'

available equity. Each year, however, he did precisely that, with the result that the net cash value of the bonds never exceeded $1,000. Knetsch surrendered the bonds after three years, prior to generating any economic gain apart from tax deductions. *Knetsch*, 364 U.S. at 364-66.

Knetsch argued that the bonds had economic substance because of their eventual annuity value. This Court recognized that the profitability of a transaction helps determine whether the transaction has economic substance by "appreciably affect[ing]" the taxpayer's "beneficial interest" apart from reducing taxes. *Id.* at 366 (internal quotation marks omitted). But the Court held that Knetsch's bonds offered no prospect for meaningful profits other than tax deductions because his borrowings each year "kept the net cash value, on which any annuity . . . would depend, at the relative pittance of $1,000." *Id.*

Knetsch further contended that the bonds had economic substance because their net cash value in 10 years would have exceeded the amounts paid as interest. *Id.* at 366 n.3. The Court also rejected this argument, stating that it was "predicated on the wholly unlikely assumption that Knetsch would have paid off in cash the original $4,000,000 'loan.'" *Id.* The exclusionary rule imposed by the majority below was based entirely on this single sentence. But, contrary to the majority's assertion, this Court did not summarily reject the taxpayer's claim about future investment as legally irrelevant. Any such ruling would have contradicted the Court's overriding premise that future profitability is legally relevant in determining economic substance. Future profitability due to a *future* investment that the taxpayer proves will be made, after all, affects the taxpayer's beneficial interest apart from tax savings as much as future profitability flowing from an *initial* investment.

As the plain language of the *Knetsch* footnote demonstrates, rather than reject the legal relevance of a future investment, the Court assessed *the factual probability*

of Knetsch's claimed investment actually being made and concluded (as was surely correct on the record before the Court) that it was "wholly unlikely."[11] *Id.* As the dissent below explained:

> [T]he Court made a credibility assessment and determined that the taxpayer did not *intend* to make the greater future investment by paying off the loan, and *therefore*, the potential future cash flows were not relevant to the economic substance analysis. The Court did not hold that, as a matter of law, a feasible projected future investment of cash in a particular plan is irrelevant to the economic substance inquiry .... The question is what the taxpayer intended.

App. 22a. By disregarding the crucial distinction between legal and factual relevance, the majority thus both misread *Knetsch*'s language and misapprehended its reasoning.

2. By arbitrarily disregarding Dow's planned and economically driven cash infusion in the middle years of its policies, the majority also squarely contradicted this Court's decision in *Frank Lyon*. Reduced to bare essentials, the issue there was whether the taxpayer (Lyon) was entitled to depreciation and other deductions as the legal owner of a building that it had simultaneously bought from and leased back to a bank, subject to various repurchase options available to the bank. The government attacked the transaction as a sham on the ground that the bank, not Lyon,

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[11] Not only had Knetsch stripped the bonds of net cash value each year and then prematurely terminated the transaction, but also Knetsch cited no evidence to the Court indicating that, in acquiring the bonds, he had even considered paying off the entire loan. To the contrary, the trial court had found that he "did not enter into [the] transaction for profit" (Transcript of Record at 57, *Knetsch*, 364 U.S. 361 (No. 23)), which this Court concluded would have required him to retire the loan. Thus, "the record permit[ted] only one resolution of the factual issue" – Knetsch never intended to pay off the loan. *Pullman-Standard v. Swint*, 456 U.S. 273, 292 (1982).

in substance owned the building. Despite the fact that Lyon had negative cash flow apart from tax deductions over the first 25 years of the transaction,[12] the Court rejected the government's argument. Although a number of considerations entered into the Court's decision, prominent among them was respect for the district court's findings about the bank's economic incentives not to exercise any of its repurchase options. Justice Stevens in dissent maintained that "speculation as to what might happen in 25 years" – *i.e.*, whether the bank would exercise one of its repurchase options – "cannot justify the *present* characterization of petitioner as the owner of the building." *Frank Lyon*, 435 U.S. at 587. This Court, however, rejected that view and instead credited (*id.* at 581) a finding by the trial court that "it was *highly unlikely*, as a practical matter, that any purchase option would ever be exercised." *Id.* at 570 (emphasis added).[13] Thus, in contrast to the majority below, the Court considered a factual finding regarding the likelihood of a future payment by a party to the transaction to be highly relevant in determining economic substance and *rejected* the argument that courts as a matter of law should not assess such likelihoods.

3. Finally, the decision below conflicts with this Court's teachings in *Duberstein*. The majority below declared that

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[12] Lyon's mortgage obligations equaled the bank's rental payments. Lyon's additional expenses, including ground rents that it owed the bank, consequently resulted in negative pre-tax cash flow. *See* 435 U.S. at 566-67.

[13] The *Frank Lyon* trial court explained that the bank's "future capital requirements and the option prices stipulated on the one hand and the reasonable rentals stipulated on the other make this quite clear." *Frank Lyon Co. v. United States*, 1975 U.S. Dist. LEXIS 11934, at *19 n.2 (E.D. Ark. 1976); *see also id.* at *1-*2, *7 (concluding that taxpayer's proposed finding explaining in more detail why a repurchase option would not be exercised was "accurate," though not adopted because merely a restatement of "facts previously found by the Court.").

"[c]ourts should be *skeptical* . . . when the asserted future profits hinge on future taxpayer action that seriously departs from past conduct, especially where such departure involves the expenditure of large sums of money." App. 13a (emphasis added). The majority then elevated this skepticism into an exclusionary rule permitting no contrary proof that the future action in fact will occur – regardless of the strength of that evidence. In *Duberstein*, the government similarly argued for "a new 'test'" of what constitutes a gift under the Internal Revenue Code, including "such propositions as . . . payments by an employer to an employee, even though voluntary, ought, by and large," not to be regarded as gifts. 363 U.S. at 287. The Court rejected the proposed test because the government's "propositions," even if correct, were "not principles of law but rather maxims of experience" and, furthermore, at best were overstatements true only in certain circumstances, but not in others. *Id. See also, e.g., Pa. Board of Probation v. Scott*, 524 U.S. 357, 364 (1998) (because an "exclusionary rule precludes consideration of reliable, probative evidence, it imposes significant costs: it undeniably detracts from the truthfinding process").

The Court's teachings in *Duberstein* apply with full force here. Skepticism is not itself a legal principle, and it cannot properly be turned into an "absolute" irrebuttable presumption trumping trial court findings. 363 U.S. at 287. Instead, as *Knetsch*, *Frank Lyon*, and *Duberstein* demonstrate, determining whether a prospective investment step in a transaction will be undertaken can properly be made only on the basis of all probative facts in each individual case, including the intent of the parties and the economic incentives that drive them – factors that the majority below incorrectly ignored.

B. The Majority's Decision Conflicts With Decisions Of Other Circuits

When confronted with whether a future investment or

other action will occur in determining the economic substance of a transaction, other courts of appeals have considered evidence of that likelihood to be highly relevant and, indeed, in assessing that likelihood have, like this Court, given great weight to precisely the two factors that the majority below disregarded: the intent of the parties and their economic incentives.

1. In *Shirar v. Comm'r*, 916 F.2d 1414 (9th Cir. 1990), the Ninth Circuit addressed whether loans obtained to fund an insurance policy, in circumstances comparable to those here, had economic substance. Shirar had purchased a policy on his wife's life to cover an estimated future estate tax liability and had paid the premiums during the first three years in part with amounts lent by the insurer against the cash value of the policy. Shirar's policy plan, however, indicated that he would not borrow against increased cash value during the following four years, and would make a disproportionately large policy payment nine years into the plan. *Id.* at 1416. Relying on *Knetsch*, the Tax Court had held that Shirar's loan transactions lacked economic substance. The Ninth Circuit reversed, distinguishing Shirar's life insurance arrangement from the one in *Knetsch* by looking to Shirar's intent, as evidenced by the policy plan, and the relevant economic incentives: "Unlike the situation in *Knetsch*," the court explained, "Shirar did not plan to borrow the entire increased cash value of the [policy] on an annual basis." *Id.* at 1418. As a result, the policy "provided Shirar with a substantial return for his out-of-pocket costs, a return absent in *Knetsch*." *Id.* "Additionally, . . . absent the increased insurance coverage provided by the [policy], Shirar would not have had sufficient liquidity to meet the estate tax obligations upon the death of his wife." *Id.* Thus, far from regarding the taxpayer's intent and economic incentives as legally irrelevant, the Ninth Circuit treated those factors as central to its analysis of the economic substance of the transaction.

2. In *Sacks v. Comm'r*, 69 F.3d 982 (9th Cir. 1995), the Ninth Circuit dealt with whether an equipment sale and leaseback lacked economic substance. The Tax Court had concluded that the taxpayer, who had bought the equipment and then leased it back to the seller, had not been at risk with respect to the debt obligations he had incurred to finance the purchase. *Id.* at 989. The Ninth Circuit reversed this finding as clearly erroneous in light of evidence that the taxpayer not only was personally liable on the obligations, but also "was likely to be able to pay them," and, indeed, it was "hard to see how he [could] expect not to pay them." *Id.* Furthermore, there was "no basis . . . for inferring any sort of 'gentleman's agreement' not to collect" on the debt. *Id.* Thus, in applying the economic substance doctrine, the Ninth Circuit did not simply rely on a contractual obligation, but rather also assessed the likelihood of the taxpayer's future action by reference to both intent and economics.

3. In *Odend'hal v. Comm'r*, 748 F.2d 908 (4th Cir. 1984), *cert. denied*, 471 U.S. 1143 (1985), the Fourth Circuit considered whether notes given by the taxpayers on which they were not personally liable in exchange for property represented genuine indebtedness. The Fourth Circuit explained that whether such a nonrecourse obligation is genuine debt depends on whether the borrower has an economic incentive to pay it off at the time the debt is incurred. *Id.* at 912. If the fair market value of the property is at least equal to the amount of the debt, the taxpayer "has an economic incentive to pay [it] off . . . rather than to lose the collateral." *Id.* On the other hand, if the amount of the debt exceeds the fair market value of the property, "the taxpayer has no equity in the property to protect and no economic incentive to pay [it] off . . . ." *Id.* Thus, the Fourth Circuit assessed the likelihood of a future cash payment by the taxpayer, not compelled by contract, by determining the taxpayer's financial interest in making the payment.

4. Other circuits have followed a similar approach in

considering the economic substance of nonrecourse obligations.[14] Particularly noteworthy is *Bailey v. Comm'r*, 912 F.2d 44, 46-47 (2d Cir. 1990), where the Tax Court denied interest deductions claimed by taxpayers on 10-year nonrecourse notes taken out to acquire certain film rights. The majority below would have affirmed this decision on the ground that the taxpayers' projected cash expenditures "drastically departed" from their prior conduct because the notes required large balloon payments at maturity dwarfing the taxpayers' initial cash outlay. The Second Circuit, however, adopted no such formalism. While agreeing with the Tax Court that "the nonrecourse nature of purchase notes, especially when they are payable out of exploitation proceeds of the purchased asset, is a factor that argues against recognition of debt as genuine" (*id.* at 48), the Second Circuit held that "this factor is not necessarily determinative":

> Other factors, particularly a reasonable relationship between the amount of the debt and the value of the securing asset, and incentives to the debtor to pay the debt out of personal assets, may require a different conclusion notwithstanding that notes are nonrecourse.

Id. Accordingly, the Second Circuit reversed and remanded for further fact-finding.

Not surprisingly, of over 500 federal cases citing *Knetsch*, *only* the decision below has found it to require the exclusion as a matter of law of the taxpayer's intended future action unless consistent with prior conduct or contractually

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14 *See, e.g., Pleasant Summit Land Corp. v. Comm'r*, 863 F.2d 263, 276 (3d Cir. 1988), *cert. denied sub nom, Comm'r v. Prussin*, 493 U.S. 901 (1989); *Lukens v. Comm'r*, 945 F.2d 92, 98 (5th Cir. 1991); *Upham v. Comm'r*, 923 F.2d 1328, 1335 (8th Cir. 1991); *Estate of Franklin v. Comm'r*, 544 F.2d 1045, 1049 (9th Cir. 1976); *Brannen v. Comm'r*, 722 F.2d 695, 701 (11th Cir. 1984).

required. On the other hand, as the cases above show, the lower courts in determining economic substance have routinely evaluated the parties' intent and the financial incentives driving them, regardless of the formality of any written agreement.

C. The Rule Adopted By The Majority Below Is Plainly Wrong

The need for this Court's review in this case is particularly pressing because the rule adopted by the majority is plainly wrong and, unless overturned, will obstruct rational resolution of future economic substance disputes. The rule asserted by the majority (1) is illogical on its face because it requires courts to ignore highly probative factors, (2) inexplicably upholds economic substance based on legal compulsion, but not on economic compulsion, (3) places no principled boundary on its own application, and (4) is founded on an irrebuttable presumption that, without warrant in the tax laws, denies deductions in commonplace business transactions.

1. The majority held it to be improper under *Knetsch* to consider the taxpayer's actual plan and financial incentives to make a future investment and the likelihood that the investment actually will be made. App. 14a n.13. But courts cannot judge the economic substance of a transaction without first determining which steps, given the parties' plans and incentives, are part of the transaction – *i.e.*, which steps will actually occur. *See Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (explaining that, in determining the substance of a transaction, "the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant"); *Shirar*, 916 F.2d at 1418 (considering taxpayer's plans and economic incentives in determining transaction's economic substance). This inquiry obviously *must* be made before the pre-tax profitability of the transaction as a whole can be assessed. By shutting the court's eyes to the taxpayer's

actual intent and the actual economics of the transaction from beginning to end, the majority's contrary rule calls for a game of blind man's bluff – which nothing in *Knetsch* condones. In fact, the evidence that the majority ruled irrelevant is likely to be among the most probative on the real economic substance of the transaction.

2. The majority's analysis of contractual obligations is equally misguided. The majority asserted that investments to be made pursuant to a contractual obligation may be taken into account because "the eventual outlay would be consistent with actual past conduct, i.e., the obligation that existed all along." App. 15a n.14. But an obligation is not the "conduct," much less the "actual" conduct, that matters. It is the investment itself that counts, which a promise cannot guarantee, since the parties may freely amend or even completely extinguish it. In any event, there is no basis for ruling that economic incentives always provide a less reliable indication that the taxpayer will actually make the investment than a contractual commitment. To the contrary, not only the courts (as discussed above), but also, importantly, the IRS itself has recognized the predictive force of economic compulsion:

> If the characterization of an instrument or a transaction for federal income tax purposes either depends on, or could be affected by, the existence of a person's legal right or option to elect a certain course of action, *the tax consequences often depend on whether the exercise (or nonexercise) of the right or option is economically compelled based on all the facts and circumstances.*

Rev. Rul. 2003-97, 2003-2 C.B. 380 (July 23, 2003) (emphasis added).

3. Furthermore, the majority's exclusionary rule requires the courts to make a subjective determination whether a planned investment reflects a "drastic departure" from the

taxpayer's prior conduct. This standard has no metes and bounds and thus provides no standard at all. In this very case, for example, the majority found Dow's planned investments to be such "drastic departures" from its prior behavior that the majority applied this standard itself rather than remand to the trial court to do so. But Dow had invested approximately $60 million in cash through 2000 in its Great West policies (*see* App. 92a) and was planning, by the majority's own reckoning, to invest only about *half* that amount in the future. *See* App. 10a n.9. If this constituted a "drastic departure," one wonders what future investment would ever be entitled to be considered under the majority's exclusionary rule.

4. At bottom the ruling below rests on an arbitrary irrebuttable presumption that taxpayers who enter into transactions requiring a substantial future investment can be counted on to actually make the investment only if they are contractually bound to do so. Nothing in the economic substance doctrine, let alone the Internal Revenue Code, supports a distinction between investments made at the beginning of the transaction and those made subsequently, or between those that are contractually stipulated and those that are planned in accordance with the taxpayer's business needs and financial incentives. The presumption embodied in the ruling below thus undermines principled application of the Internal Revenue Code. If permitted to stand, the presumption – which the government has now endorsed (*see* App. 216a; App. 221a) – will frustrate not only long-term financing transactions, but also many other legitimate business transactions that are not initially profitable but become so over time. *See* Sheryl Stratton, *Circular 230 Changes Moving Slowly as Courts Offer Up Shelter Analyses*, 2006 Tax Notes Today 182-2 (Sept. 20, 2006) ("The conflict with *Knetsch* and the de novo standard of review espoused by the court in *Dow* threaten the legitimacy for tax purposes of many business transactions that would be

under review by the Sixth Circuit that take time and more than one contribution of cash to generate profits") (quoting Jeff Paravano, former Senior Advisor to the Assistant Secretary for Tax Policy at the Department of Treasury); Richard M. Lipton, *What Will Be the Long-Term Impact of the Sixth Circuit's Divided Decision in* Dow Chemical*?*, 104 J. Tax'n 332, 337 (2006) ("The expansive interpretation of *Knetsch* . . . is likely to continue the impression that the government is more interested in favorable results than the rule of law, which can only lead to long-term adverse consequences.").

As the preceding discussion shows, the irrebuttable presumption imposed by the decision below is at odds with this Court's decisions and the decisions of other courts of appeals. Thus, the Sixth Circuit's ruling urgently calls for this Court's review.

CONCLUSION

For the foregoing reasons, the petition should be granted.[15]

Respectfully submitted,

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15 In view of the patent conflict between the decision below and this Court's holdings in *Knetsch*, *Frank Lyon*, and *Duberstein*, the Court may wish to consider summary reversal.

APPENDIX

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 03-2360

THE DOW CHEMICAL COMPANY,
Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF MICHIGAN AT BAY CITY.
NO. 00-10331—DAVID M. LAWSON, DISTRICT JUDGE.

JUNE 3, 2005, ARGUED
JANUARY 23, 2006, DECIDED AND FILED

BEFORE: RYAN, MOORE, AND COOK, CIRCUIT JUDGES.

COUNSEL

ARGUED: Dennis M. Donohue, UNITED STATES DEPARTMENT OF JUSTICE, Washington, D.C., for Appellant. John B. Magee, McKEE NELSON LLP, Washington, D.C., for Appellee.

ON BRIEF: Dennis M. Donohue, Richard Farber, Gilbert S. Rothenberg, Robert W. Metzler, James D. Hill, UNITED STATES DEPARTMENT OF JUSTICE, Washington, D.C., for Appellant. John B. Magee, Gerald Goldman, Raj Madan, Richard C. Stark, Sheri A. Dillon, McKEE NELSON LLP, Washington, D.C., for Appellee.

MOORE, J., delivered the opinion of the court, in which COOK, J., joined. RYAN, J. (pp. 21a-34a), delivered a separate dissenting opinion.

OPINION

KAREN NELSON MOORE, Circuit Judge. In 1988 and 1991, Plaintiff-Appellee The Dow Chemical Company ("Dow") purchased corporate-owned life insurance ("COLI") policies on the lives of thousands of its employees. In the taxable years 1989 to 1991, Dow claimed deductions for interest incurred on loans used to pay the COLI premiums and for fees related to the administration of the policies. The Internal Revenue Service ("IRS") disallowed these deductions and assessed tax deficiencies and interest, which Dow paid under protest and attempted to recover by suing for a refund. Following a bench trial, the district court ruled that the IRS had improperly disallowed the deductions and ordered judgment in Dow's favor.

Because the COLI plans were economic shams and the deductions therefore were properly disallowed, we **REVERSE** the district court's judgment and remand for entry of judgment in favor of the United States.

I. BACKGROUND

A. Factual Background

The district court conducted a bench trial lasting over two months, heard testimony from twenty-six witnesses, and received 1,526 exhibits and numerous factual stipulations. The facts of the case and the parties' arguments are discussed at length in the district court's two thorough opinions. *Dow Chem. Co. v. United States* (*Dow I*), 250 F. Supp. 2d 748 (E.D. Mich. 2003); *Dow Chem. Co. v. United States* (*Dow II*), 278 F. Supp. 2d 844 (E.D. Mich. 2003). Because the case turns not on factual disputes but on issues of law, we present here only a brief factual background.

In 1988, Dow purchased COLI policies on the lives of 4,051 employees from Great West Life Assurance Company ("Great West"). In 1991, Dow purchased COLI policies on the lives of 17,061 employees from Metropolitan Life Insurance Company ("MetLife"). Dow, which was both the owner and the beneficiary of these policies, paid the premiums through two primary funding mechanisms.

First, Dow borrowed money from the insurers, using the cash values of the policies as collateral.[1] These policy

[1] The policy-loan transactions were structured as follows: "Dow would receive a bill from the insurance company that netted the premium and interest charges against the proceeds of a loan that was made on the first day of the policy year, leaving a relatively small balance to pay in cash. The premium payment created value in the policy, which was used as security for repayment of the loan." *Dow I*, 250 F. Supp. 2d at 812.

loans were the principal source of funding during the first, second, third, eighth, and ninth years of the Great West plan and during the first three years of the MetLife plan. For example, Dow paid (i) Great West's first-year premium of $40,582,000 using $38,866,000 in proceeds from the policy loan and $1,717,000 of its own cash[2] and (ii) MetLife's first-year premium of $170,510,000 using $158,756,000 in proceeds from the policy loan and $11,754,000 of its own cash.

Second, Dow made partial withdrawals from the unencumbered cash values of the policies (i.e., the value not already used as collateral for a policy loan).[3] Partial withdrawals were the principal source of funding during the fourth through seventh and tenth through thirteenth years of the Great West plan and during the fourth through eighth years of the MetLife plan. For example, Dow paid (i) Great West's fourth-year premium of $40,360,000 (plus $11,278,000 in interest accrued on the policy loans) using $45,149,000 in proceeds from the partial withdrawals and $6,489,000 of its own cash and (ii) MetLife's fourth-year premium of $169,770,000 (plus $38,132,000 in interest) using $195,779,000 in proceeds from partial withdrawals and $12,123,000 of its own cash.[4]

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[2] Where, as here, the component figures to be summed do not add to the stated total, it is due to rounding.

[3] These partial-withdrawal transactions were structured as follows: "(1) the gross premium was deemed paid; (2) the deemed payment of the premium created cash value; (3) Dow made a partial withdrawal of the cash value; and (4) the partial withdrawal was used to offset approximately 90% of the premium and accrued loan interest." *Dow I*, 250 F. Supp. 2d at 814. Under each plan these steps were carried out effectively simultaneously.

[4] During the tenth through thirteenth years of the Great West plan, dividends from the policies were another source of funding. For example, Dow paid the tenth year's premium of $3,702,000 (plus

All told, from 1988 to 2000, Dow paid $377,062,000 in premiums and $131,986,000 in interest to Great West from the following sources: $201,317,000 in policy loans, $238,844,000 in partial withdrawals, $9,203,000 in policy dividends, and $59,679,000 (about 16% of the premiums) in cash. From 1991 to 1998, Dow paid $849,890,000 in premiums and $239,371,000 in interest to MetLife from the following sources: $509,574,000 in policy loans, $495,844,000 in partial withdrawals, and $83,844,000 (about 10% of the premiums) in cash.

In addition to the payment mechanisms described above, both COLI plans shared several other pertinent characteristics. First, both plans were projected to generate negative pre-deduction (i.e., without taking into account the benefit of income-tax deductions) cash flows for many years – eighteen and seventeen years for the Great West and MetLife plans, respectively – before eventually generating positive cash flows contingent on the infusion of large amounts of cash by Dow. The net present value ("NPV") of these cash flows was either positive or negative, depending on the discount rate used in the analysis. Second, neither plan was projected to experience significant inside build-up (i.e., the accrual of interest on the value of the policies) in the short term, because any such value would either be stripped from the policies (through the partial withdrawals) or encumbered (though the loans against the policies). If Dow injected large sums of cash into the policies, however, the plans would accrue significant interest in the long term. Third, both plans limited Dow's potential mortality gain (i.e., the receipt of greater-than-expected death benefits due to a greater-than-expected number of deaths among the

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$14,442,000 in interest accrued on the policy loans) using $12,343,000 in proceeds from the partial withdrawals, $3,685,000 in policy dividends, and $2,116,000 in its own cash. Dow did not use policy dividends to make any payments to MetLife.

covered employees): Great West could recover its mortality losses through rate adjustments, while MetLife could assess charges to recoup its mortality losses.

In the taxable years 1989 to 1991, Dow claimed deductions totaling $33,004,360 for interest paid on loans used to pay the COLI premiums and for fees related to the administration of the policies.[5] The IRS disallowed these deductions and assessed tax deficiencies and interest totaling $22,209,570.[6] Dow paid this amount and filed administrative protests that the IRS denied.

B. Procedural Background

Dow filed suit in the district court to recover by refund the sum it had paid under protest, plus interest. The government argued that Dow's deductions were improper because the COLI plans were economic shams. Following a bench trial, the district court ruled that the IRS had improperly disallowed the deductions because the COLI plans were not economic shams and consequently ordered judgment in Dow's favor. The government appeals this conclusion and two subsidiary rulings. First, the district court credited the discount rate (and concomitant NPV) offered by Dow rather than the one offered by the government. Second, the district court excluded projections of the COLI plans' performance that Dow had submitted

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[5] In taxable years 1989, 1990, and 1991, Dow claimed deductions for (i) interest expenses of $3,843,813, $12,968,778, and $13,491,825, respectively, and (ii) administrative fees of $168,563, $2,175,160, and $356,221, respectively.

[6] For taxable years 1989, 1990, and 1991, the IRS assessed (i) tax deficiencies in the amount of $1,367,386, $3,043,326, and $6,836,910, respectively, and (ii) interest in the amount of $1,781,778, $3,235,630, and $5,944,540, respectively.

with its administrative protests because they were statements made in settlement negotiations under Rule 408 of the Federal Rules of Evidence.[7]

II. ANALYSIS

A. General Principles

"The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." *Gregory v. Helvering*, 293 U.S. 465, 469 (1935). In the instant case, Dow attempted to decrease its tax liability principally through I.R.C. § 163(a) (26 U.S.C. § 163(a)), which permits a taxpayer to deduct "all interest paid or accrued within the taxable year on indebtedness." For life insurance contracts, the deduction of interest on indebtedness is circumscribed:

> No deduction shall be allowed for . . . any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance . . . contract . . . pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract . . . .

I.R.C. § 264(a)(3). This prohibition does not apply "if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness." I.R.C. § 264(d)(1).

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[7] Other aspects of the district court's opinion were not appealed and therefore are not discussed here.

Even under this safe-harbor, however, the Code provision in effect when the instant plans were purchased (1988 and 1991) limited the deduction to $50,000 of indebtedness per insured life. I.R.C. § 264(a)(4) (1988).

Of course, a taxpayer is not automatically entitled to every claimed deduction. "[A]n income tax deduction is a matter of legislative grace and . . . the burden of clearly showing the right to the claimed deduction is on the taxpayer." *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992). Moreover, even if a transaction is in "formal compliance with Code provisions," a deduction will be disallowed if the transaction is an economic sham. *Am. Elec. Power Co. (AEP) v. United States*, 326 F.3d 737, 741 (6th Cir. 2003), *cert. denied*, 540 U.S. 1104 (2004). "The proper standard in determining if a transaction is a sham is whether the transaction has any practicable economic effects other than the creation of income tax losses." *Rose v. Comm'r*, 868 F.2d 851, 853 (6th Cir. 1989). If the transaction has economic substance, "the question becomes whether the taxpayer was motivated by profit to participate in the transaction." *Illes v. Comm'r*, 982 F.2d 163, 165 (6th Cir. 1992), *cert. denied*, 507 U.S. 984 (1993). "If, however, the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the [subjective] inquiry is never made." *Id.*; *see also Rose*, 868 F.2d at 853 ("This court will not inquire into whether a transaction's primary objective was for the production of income or to make a profit, until it determines that the transaction is bona fide and not a sham.").

B. Standard of Review

In conducting the economic-sham inquiry, the district court's findings of fact are reviewed for clear error. *AEP*, 326 F.3d at 741 (citing *Rink v. Comm'r*, 47 F.3d 168, 172

(6th Cir. 1995)). The district court's ultimate conclusion that a transaction is or is not an economic sham is reviewed de novo.[8] *Id.* at 742.

C. Economic Substance of Dow's COLI Plans

Several courts, including this one, have addressed the economic substance of COLI plans, finding the plan to be a sham on each occasion. *Id.* at 744; *IRS v. CM Holdings, Inc.* (*In re CM Holdings, Inc.*), 301 F.3d 96, 102-03 (3d Cir. 2002); *Winn-Dixie Stores, Inc. v. Comm'r* (*Winn-Dixie*), 254

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[8] A panel of this court once noted in an economic-sham case that "[w]here the judgment below is ultimately a finding of fact, it is well-settled that the determination of the Tax Court is binding on the appellate court unless clearly erroneous." *Ratliff v. Comm'r*, 865 F.2d 97, 98 (6th Cir. 1989) (alteration in original) (internal quotation marks omitted). Two decisions issued mere months after *Ratliff* clarified that while the factual findings underlying a sham determination are reviewed for clear error, the legal standards employed and the ultimate conclusion are reviewed de novo. *Kennedy v. Comm'r*, 876 F.2d 1251, 1254 (6th Cir. 1989); *Rose*, 868 F.2d at 853. Since this trio of decisions in 1989, we have consistently followed the more nuanced formulation of *Kennedy* and *Rose* whenever we have explicitly stated the standard of review. *AEP*, 326 F.3d at 741-42; *Rink*, 47 F.3d at 171; *Smith v. Comm'r*, 937 F.2d 1089, 1096 (6th Cir. 1991); *Bryant v. Comm'r*, 928 F.2d 745, 748 (6th Cir. 1991). Although there may appear to be some tension between *Ratliff* and our subsequent cases, we recognized in *AEP* that the *Ratliff* panel "did not specifically hold that the ultimate question of whether a transaction is a sham is to be reviewed under the clearly erroneous standard." *AEP*, 326 F.3d at 742. Furthermore, employing different standards of review for the factual and ultimate questions is more consistent with the Supreme Court's teaching that "[t]he general characterization of a transaction for tax purposes is a question of law subject to review. The particular facts from which the characterization is to be made are not so subject." *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978). Both parties agree that although factual findings are reviewed for clear error, the ultimate question of whether the transaction is an economic sham is reviewed de novo. Appellant's Br. at 33; Appellee's Br. at 38.

F.3d 1313, 1317 (11th Cir. 2001), *cert. denied*, 535 U.S. 986 (2002). These courts have looked to several indicators of the COLI plans' potential economic benefits: (i) projected pre-deduction cash flows, "'[(ii)] mortality gains to the beneficiary, who does not pay tax on proceeds, and [(iii)] interest-free inside build-up [the accrual of interest on the policy value].'" *AEP*, 326 F.3d at 742 (last alteration in original) (quoting *CM Holdings*, 301 F.3d at 103). We examine the objective economic substance of Dow's COLI plans against each of these standards below.

1. Pre-Deduction Cash Flows

In each prior case addressing the economic substance of a COLI plan, the court found that, without the benefit of the claimed interest deductions, the plan generated negative cash flows. *AEP*, 326 F.3d at 742; *CM Holdings*, 301 F.3d at 103; *Winn-Dixie*, 254 F.3d at 1316. Indeed, we have called a COLI plan's negative pre-deduction cash flows (that become positive when the benefit of interest deductions is considered) a "hallmark[] of an economic sham." *AEP*, 326 F.3d at 742.

The district court found that the Great West and MetLife plans would generate negative pre-deduction cash flows during their first eighteen and seventeen years, respectively. Unlike the COLI plans in *AEP*, *CM Holdings*, and *Winn-Dixie*, however, Dow's plans were not projected to be cash-flow negative for their entire durations. The district court found that Dow intended to infuse large sums of cash into the plans during their middle years,[9] which would make

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[9] The district court did not specify how large this infusion would have had to be in order to make the COLI plans profitable. Based on the following evidence and findings, however, we can infer that the figure was quite large indeed – about $315 million.

the plans cash-flow positive in their later years. Because the plans were projected to have both cash-flow-negative and cash-flow-positive years, the district court applied a NPV analysis to determine the overall cash flow.[10] Finally, the district court credited the discount rate utilized by Dow's experts and found that the NPV of each plan was positive.

The government objects to the district court's finding that Dow intended to inject large amounts of cash into the plans in their middle years. Reversing this finding would have a domino effect favorable to the government: it would undermine the finding that the plans would generate positive cash flows in their later years, which would in turn preclude the finding that each plan had a positive NPV. Review of this factual finding for clear error is only necessary, however, if such highly-contingent cash flows are relevant as a matter of law to the economic-sham analysis.

With respect to the Great West plan, Dow asserts that it relied on two illustrations (Cash Flow # 1 and # 2) in making its purchase decision. Appellee's Br. at 12. The district court credited "Dow's intention to cap loans at $50,000 and withdraw only to basis," *Dow I*, 250 F. Supp. 2d at 802, which reflects only Cash Flow #1, Appellee's Br. at 9. This illustration shows cash infusions of about $30 million during the middle years. Joint Appendix ("J.A.") at 1711.

With respect to the MetLife plan, the district court credited Dow's assertion that it relied on an illustration called Case # 23. *Dow I*, 250 F. Supp. 2d at 809; Appellee's Br. at 16. This illustration shows cash infusions of about $285 million during the middle years (after multiplying the illustration's per-insured infusion by the 17,800 employees that Dow projected to be covered by the plan, *Dow I*, 250 F. Supp. 2d at 784-85; Appellee's Br. at 15). J.A. at 898.

10 "In transactions that are designed to yield deferred rather than immediate returns, present value adjustments are, as the courts have recognized, an appropriate means of assessing the transaction's actual and anticipated economic effects." *ACM P'ship v. Comm'r*, 157 F.3d 231, 259 (3d Cir. 1998) (citing cases).

Unfortunately, the prior COLI-plan decisions are unhelpful in resolving this legal question because in each case the court found the pre-deduction cash flow to be negative for every year of the plan and there was no possibility of future profitability upon the materialization of some contingency.[11]

The Supreme Court has, however, provided useful guidance. In *Knetsch v. United States*, 364 U.S. 361 (1960), the Court reviewed a transaction involving the taxpayer's purchase of $4 million worth of 30-year bonds and his simultaneous borrowing against them, which generated hundreds of thousands of dollars in interest deductions in just two years. *Id.* at 362-63. The taxpayer terminated the transaction after three years: he surrendered the bonds (now worth $4,308,000), his loan (now worth $4,307,000) was cancelled, and he received the difference ($1,000). *Id.* at 364. The Court upheld the IRS's disallowance of the taxpayer's loan-interest deductions as the product of a sham transaction. *Id.* at 366.

Two aspects of the Court's opinion shed light on the current inquiry. First, the Court observed that if, instead of terminating the transaction, the taxpayer had held the bonds to maturity and continued to operate as he had done for the first three years, he would have received an annuity worth $1,000. *Id.* at 364. Second, the Court summarily rejected the taxpayer's argument that the transaction would have become profitable in ten years if he paid off the original $4

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[11] Beyond the COLI-plan context, courts have disfavored the deduction of interest paid on investments with contingent benefits. *See, e.g., Coleman v. Comm'r*, 87 T.C. 178, 208-09 (1986), *aff'd*, 833 F.2d 303 (3d Cir. 1987); *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 92-93 (4th Cir. 1985); *Smoot v. Comm'r*, 61 T.C.M. (CCH) 2897, 1991 WL 97650 (1991); *Goldwasser v. Comm'r*, 56 T.C.M. (CCH) 606, 1988 WL 118617 (1988); *Zegeer v. Comm'r*, 54 T.C.M. (CCH) 1203, 1987 WL 49205 (1987).

million loan. *Id.* at 366 n.3. The first statement demonstrates that potential future profitability can be relevant in assessing whether an ongoing transaction is an economic sham. The contrast between the first and second statements reflects a more nuanced lesson. Courts may consider future profits contingent on some future taxpayer action, but only when that action is consistent with the taxpayer's actual past conduct. Courts should be skeptical, however, when the asserted future profits hinge on future taxpayer action that seriously departs from past conduct, especially where such departure involves the expenditure of large sums of money.[12]

These principles have obvious relevance to the instant case. It was proper for the district court to consider whether Dow's plans would be profitable in the future; indeed, in each prior COLI-plan case, the court looked to future cash flows. The same cannot be said, however, for the district court's consideration of positive cash flows that were contingent on Dow's eventual spending of significant amounts of cash. Like the transaction in *Knetsch*, the instant COLI plans would become profitable only upon the taxpayer's large future outlay of additional cash, and, considering that Dow had heretofore made no similar cash infusions, such additional spending would be a drastic

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[12] The dissent objects to our reading of *Knetsch*, asserting that the Court simply "determined that the taxpayer did not *intend* to make the greater future investment by paying off the loan, and *therefore*, the potential future cash flows were not relevant to the economic substance analysis." Dissent at 22a. Our reading of *Knetsch* is consistent with this statement. What the dissent ignores (and we recognize) is the *reason* behind the Court's determination: the large future investment would be altogether inconsistent with his past conduct. This is what made paying off the loan "wholly unlikely." *Knetsch*, 364 U.S. at 366 n.3.

departure from the taxpayer's past conduct.[13] Moreover, there was no contractual provision requiring Dow to make substantial cash infusions in the future. In light of the teachings of *Knetsch*, the district court erred in including in

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[13] As the facts recited in the text demonstrate, the policy premiums had been funded principally through loans against and withdrawals from the policies, with Dow using little of its own cash. Yet the $315 million in projected future investments purportedly would have been coupled with Dow limiting its borrowing and withdrawals. *Dow I*, 250 F. Supp. 2d at 801-02, 807, 809-10. On these facts, there can be no doubt that the projected cash infusions would have required Dow to depart drastically from its past conduct. Thus, we leave for another day the consequences of less drastic departures. This obviates the dissent's concern that our holding prohibits the consideration of contingent future profits whenever it depends on future investment that is merely "greater than the past investment." Dissent at 22a.

Also, without citing any authority, the dissent argues that we should also consider "whether the projected future investment is feasible and there is evidence that it is likely to occur." Dissent at 22a. While we agree that the *in* feasibility of a future investment is indicative of a sham transaction, the fact that an investment *is* feasible is less likely to provide useful information because large future investments will almost always be feasible for large corporations or other resource-rich taxpayers. A factor that is too easily met is no factor at all.

A likelihood factor presents problems of its own. How would one determine likelihood, i.e., what types of evidence would one consider? (The dissent does not say.) One possibility is the profitability of the transaction, because a taxpayer is more likely to make a future investment if it will make the transaction profitable. But this would be circular, requiring us to look to the profitability of the transaction to determine the likelihood of the investment, which we would then use to determine the economic substance (i.e., profitability) of the transaction all over again. Another possibility is the taxpayer's plans, because internal deliberations might show that a future investment is likely to occur. But that crosses over to the subjective inquiry that we do not conduct until the transaction is determined to have economic substance in the first place. *Illes*, 982 F.2d at 165. In light of these difficulties, the better course is to remain true to *Knetsch* by limiting the inquiry to whether the future investment drastically departs from past conduct.

its cash-flow analysis the highly-contingent positive cash flows projected for later years.[14] When the future infusion of cash is properly removed from the analysis, only negative cash flows remain. Therefore, without the benefit of the interest deductions, the COLI plans were cash-flow negative for all relevant periods, which is a "hallmark[] of an economic sham." *AEP*, 326 F.3d at 742.

Our holding that the future positive cash flows should have been ignored makes it unnecessary to reach the government's appeal of the district court's (i) choice of discount rate to credit in the NPV analysis and (ii) exclusion of Dow's tax protest letters under Rule 408 of the Federal Rules of Evidence. First, the removal of the highly-contingent positive cash flows from the analysis leaves only negative cash flows, which of course yield a negative NPV no matter what the discount rate. Second, the government offered the tax protest letters to cast doubt on Dow's intent to inject large amounts of cash into the plans in the future, which is irrelevant in light of our holding that this putative additional outlay (or, more precisely, the profits contingent on such spending) should be disregarded as a matter of law.

2. Inside Build-Up

In each prior COLI-plan case, the court found that the plan ensured that at regular intervals net equity was adjusted

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[14] We do not hold that future profits contingent on new expenditures by the taxpayer may *never* be considered. For example (as we suggest in the text), if a taxpayer were contractually obliged to infuse additional cash into an investment at some point in the future, such spending would not constitute a serious departure from past conduct that should be disregarded under *Knetsch*. Instead, the eventual outlay would be consistent with actual past conduct, i.e., the obligation that existed all along. Of course, Dow was under no such obligation in the instant case.

to zero or some small number. *AEP*, 326 F.3d at 740, 742; *CM Holdings*, 301 F.3d at 103; *Winn-Dixie Stores, Inc. v. Comm'r*, 113 T.C. 254, 281, 284 (1999). This low or zero net equity precluded the taxpayer from realizing the benefit of inside build-up, because there would be little or no net equity to build up (i.e., earn interest).

The district court found that "on the last day of each of policy years four through seven, the cash value of Dow's Great West and MetLife policies was fully encumbered, yielding virtually zero net equity." *Dow I*, 250 F. Supp. 2d at 814. The district court also noted that Gary Lake, an actuarial consultant who advised Dow on the COLI plans, *id.* at 766, "stated that for some of the years the purpose was to have low net equity," *id.* at 774. Based on its finding that in the future Dow would infuse the plans with large sums of cash, however, the district court held that the company "stood to realize substantial economic gain from tax-free inside build-up" with respect to both plans. *Id.* at 807; *see also id.* at 810.

For the same reasons discussed above in the context of cash flows, the district court erred in considering in its inside build-up analysis the prospect of large cash investments that might be (but did not have to be) made in the future. Instead, given the district court's factual findings with respect to Dow's actual conduct of maintaining little or no net equity, a simple application of *AEP*, *CM Holdings*, and *Winn-Dixie* yields the result that Dow would have been unable to realize the benefit of inside build-up. This conclusion further suggests that the COLI plans were an economic sham.

3. Mortality Gains

The district court found that the plans contained features designed to neutralize the taxpayer's ability to realize mortality gains. The district court nevertheless found that the COLI plans were not mortality neutral because neither one "contain[ed] a 100% retrospective adjustment mechanism," a requirement that the court divined from the three prior COLI-plan decisions.[15] *Dow I*, 250 F. Supp. 2d at 811; *see also id.* at 808, 810. The district court reiterated its application of this 100%-adjustment requirement when it explained in its amended opinion that "a plan that is not designed to *eliminate every dime of mortality profit* . . . cannot be 'mortality neutral' over the long term." *Dow II*, 278 F. Supp. at 851 (emphasis added).

In the three prior COLI-plan cases, the mortality provisions were deemed neutral, making the potential for

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[15] The district court read the three cases as follows:

> [C]ourts found that the COLI plans were flawed because of devices designed into the plans that eliminated the transfer of risk. Those courts thus adopted the government's terminology and found that the plans were "mortality neutral" when, after the relevant period, usually a year, the cost of insurance (COI) and death benefits were "trued up" retrospectively. That is, when there is an agreement contained in the plan to make payments after the conclusion of a policy year so that the COI equals the amount paid out in death benefits, risk is eliminated and, as insurance, the COLI transaction is economically meaningless.

Dow I, 250 F. Supp. 2d 807-08 (citing *Winn-Dixie*, 113 T.C. at 268-69, 285; *IRS v. CM Holdings, Inc. (In re CM Holdings, Inc.)*, 254 B.R. 578, 632-35 (D.Del. 2000); *Am Elec. Power Co. v. United States*, 136 F. Supp. 2d 762, 777, 787-88 (S.D. Ohio 2001)).

mortality gains a sham. Yet two of the three previously challenged plans clearly did *not* eliminate 100% of all mortality gains and losses. In *CM Holdings*, the taxpayer received a total mortality gain of $1.3 million over the first eight years of the plan. 301 F.3d at 101. The Third Circuit noted that the insurance company "assessed [the taxpayer] surcharges . . . to recoup its losses and ensure mortality neutrality going forward." *Id.* at 103. The *CM Holdings* district court's description of the plan reveals, however, that these surcharges did not constitute a 100% elimination of mortality gains. The plan contained a provision capping maximum cost-of-insurance ("COI") charges, which led the district court to conclude that the insurance company "may never recoup [the taxpayer's] mortality windfall through increased COI charges." *In re CM Holdings*, 254 B.R. 578, 635 & nn.70-71 (D. Del. 2000).

The precise details of the mortality-neutralizing provision in *AEP* are less clear than in *CM Holdings* but still suggestive of less-than-complete elimination of mortality gains. The taxpayer was advised that the plan's mortality mechanism would "result in a *much closer* match" between expected and actual death benefits.[16] *Am. Elec. Power, Inc. v. United States*, 136 F. Supp. 2d 762, 777 (S.D. Ohio 2001) (emphasis added). The use of the phrase "much closer" rather than a word like "complete," "total," or "absolute" implies that the plan did not provide for 100% adjustment. Indeed, over a nine-year period, the taxpayer experienced a mortality loss (i.e., there were *fewer* deaths than expected, so

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16 Contrary to the dissent's assertion, Dissent at 28a, the next sentence of the advice given the taxpayer – "This will eliminate any volatility or variation in the cash flow that we are expecting in each year of the plan" – does not undermine the sentence quoted in the text. Indeed, the use of the qualifier "that we are expecting" to modify "volatility or variation" suggests that the taxpayer's mortality gains would not be completely eliminated if they exceeded expectations.

it received *less* in death benefits than it paid for) of $38.8 million between projected and actual death benefits that apparently went unadjusted. *Id.* at 788. There is nothing in the opinion to indicate that a mortality *gain* would have been completely eliminated even though a mortality *loss* was left uncorrected. Further supporting this conclusion is the fact that the plan in *AEP* was "the same COLI plan . . . offered by the same insurer and sold by the same brokers" as the one in *CM Holdings*, *id.* at 768-69, which (as has already been shown) limited the insurer's ability to recoup the taxpayer's mortality gains.

Finally, the precise details of the mortality-neutralizing provision in *Winn-Dixie* are unclear. The plan provided for the creation of a claims-stabilization reserve ("CSR") that was funded by COI charges and from which death claims were paid. *Winn-Dixie*, 113 T.C. at 268. If the taxpayer experienced mortality gains in a given year, then the excess was deducted from the CSR. *Id.* at 268-69. "[T]he function of the claims stabilization reserve was to ameliorate fluctuations in actual mortality experience." *Id.* at 285. The *Winn-Dixie* district court's opinion does not elaborate, however, what would happen if the taxpayer's mortality gains exhausted the CSR. While one might imagine the insurer recouping the gains through some other mechanism, one might also imagine the taxpayer keeping any mortality gains over and above the value of the CSR. In light of this uncertainty, the district court below could not have concluded that the *Winn-Dixie* plan provided for the complete elimination of mortality gains.

This review of the cases demonstrates that a "100% retrospective adjustment mechanism" requirement simply cannot be discerned from the past COLI-plan cases. In fact, a rule that permitted a COLI plan to be deemed mortality neutral only upon proof that "every dime of mortality profit"

is eliminated would outright conflict with the facts of two of the three cases. Therefore, the district court erred by imposing such a high hurdle as a prerequisite to finding that Dow's plans were designed to neutralize mortality gains.

When this erroneously high bar is removed, it is clear that the COLI plans were designed to reduce (even if not by 100%) Dow's ability to realize mortality gains. The Great West plan permitted the insurer to recoup its mortality losses (i.e., Dow's mortality gains) through rate adjustments. *Dow I*, 250 F. Supp. 2d at 808. The MetLife plan gave the insurer "the right to increase COI charges to recoup losses if claims for death benefits exceeded COI charges." *Id.* at 810. The fact that such increase was limited by a stop-loss provision, *id.*, is no bar to a finding of mortality neutrality, because (as discussed above) the recoupment mechanism in *CM Holdings* also was capped. It is apparent, then, that these features are sufficiently similar to the other COLI-plan cases for us to conclude that Dow would not significantly benefit from mortality gains. This conclusion provides further evidence that the COLI plans were an economic sham.

4. Summary

Courts have recognized three non-tax benefits relevant to the economic-substance analysis of COLI plans: positive cash flows, inside build-up, and mortality gains. Dow's COLI plans did not generate any of these benefits. Because the plans did not have "any practicable economic effects other than the creation of income tax losses," *Rose*, 868 F.2d at 853, we conclude that they had no economic substance. This conclusion makes it unnecessary to discuss Dow's subjective motivation. *Illes*, 982 F.2d at 165.

III. CONCLUSION

For the reasons set forth above, we **REVERSE** the district court's judgment and remand for entry of judgment in favor of the United States.

DISSENT

RYAN, Circuit Judge, dissenting. My colleagues conclude that, as a matter of law, future profits contingent on taxpayer action are an appropriate component of the economic substance calculus *only* when that action comports with the taxpayer's actual past conduct related to the transaction in question. I disagree. In my opinion, there is no such precedential rule of law and no warrant for creating one in this case. The validity of Dow's COLI plans as investments having economic substance turns on the district court's findings of fact and the sufficiency of evidence supporting those findings. I would affirm the judgment in favor of Dow because I believe that the district court correctly applied the law of this circuit to factual findings that are not clearly erroneous.

I have no disagreement with the majority opinion's statement of the complex factual details of Dow's COLI program, and its summary of the general principles of this court's economic substance doctrine. My disagreement is with the legal principles my colleagues invent and mistakenly attribute to *Knetsch v. United States*, 364 U.S. 361 (1960).

I agree with my colleagues that *Knetsch* demonstrates that potential future profitability is relevant to the inquiry of

whether a long-term investment plan is an economic "sham," as that unfortunate term has been used by the IRS and some of our federal courts. But my colleagues read into *Knetsch* far more than the Supreme Court wrote in that case concerning the Court's refusal to accept the taxpayer's argument that the transaction would have become profitable in ten years had he paid off the original $4 million loan.

The Supreme Court did not summarily reject the taxpayer's argument; rather, it stated that the argument was "predicated on the wholly unlikely assumption that Knetsch would have paid off in cash the original $4,000,000 'loan.'" *Id.* at 366 n.3. My colleagues insist that this language implies a general principle of law that future profits are not even *relevant* to the economic substance inquiry when the taxpayer's projected future investment in a particular plan is greater than its past investment in that plan, regardless whether the projected future investment is feasible and there is evidence that it is likely to occur. I read *Knetsch* to indicate only that the Court made a credibility assessment and determined that the taxpayer did not *intend* to make the greater future investment by paying off the loan, and *therefore*, the potential future cash flows were not relevant to the economic substance analysis. The Court did not hold that, as a matter of law, a feasible projected future investment of cash in a particular plan is irrelevant to the economic substance inquiry, when that investment is greater than the past investment in that plan. The question is what the taxpayer intended.

If Dow's potential future cash flows are not arbitrarily excluded from the economic substance inquiry, this case turns on the district court's findings of fact regarding the intended operation of Dow's COLI plans. The district court made two crucial findings of fact: (1) Dow intended to operate its plans such that it would realize the

benefits of tax-deferred inside buildup; and (2) Dow's plans transferred mortality risk to the insurers on the aggregate. The court then correctly applied the legal principles set down in the so-called sham-COLI cases, and concluded that, unlike the sham COLI plans, Dow's plans had economic substance as a long-term investment program.

The sham-COLI cases explain that the two main benefits of life insurance plans other than the potential for tax *deductions* are: (1) mortality payments to the beneficiary, which are not taxable; and (2) the accrual of tax-deferred interest on policy value (inside buildup), that is, the increase in the policy's cash value attributable to interest income earned upon the investment of the cash value. The plans in the sham-COLI cases were economic shams because they failed to realize *either* of the two benefits of a life insurance plan and because they were created solely for the tax benefit of deductions. *See Am. Elec. Power Co. v. United States*, 326 F.3d 737 (6th Cir. 2003) (*AEP*); *In re CM Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002); *Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313 (11th Cir. 2001).

In this case, the district court concluded, on the basis of its two central factual findings, that, unlike the sham-COLI plans, Dow's COLI plans realized both of the non-deduction benefits of life insurance policies and therefore had economic substance. Unless *both* of those factual findings by the district court are clearly erroneous—and I conclude they are not—the court's judgment for Dow should be affirmed.

I. Inside Buildup

The first basis for the district court's determination that Dow's COLI plans had economic substance was its finding that Dow would realize the benefits of the tax-

deferred inside buildup of the policies. There were no such benefits in the COLI plans found to be shams in *AEP*, *CM Holdings*, and *Winn-Dixie*. Dow's pre-purchase projections showed that the plans generated positive cash flows, even in the absence of the interest deductions. The district court noted that although the pre-deduction cash flows were negative for the first 18 years of the plan, positive cash flows, delayed for 18 years, were consistent with Dow's subjective business purpose of funding retiree benefit expenses in the long term. *Dow Chem. Co. v. United States*, 250 F. Supp. 2d 748, 806 (E.D. Mich. 2003).

I think the district court got it right, in first analyzing each of Dow's COLI plans as a *whole* and then correctly concluding that the plans had economic substance, because, among other things, they realized the benefits of inside buildup. That conclusion rested, first, upon the court's factual finding that Dow intended from the outset to cap policy loans at $50,000, to withdraw funds only to basis, and to invest cash into the Great West and MetLife plans after 17 years. *See id.* at 802, 809. The district court based this finding not only on the testimony of Dow's witnesses, but also on contemporaneous documentation introduced by Dow, including Dow's original 1987 Request for Proposals (RFP) to the insurance industry; analysis of proposals by Dow's actuarial consultant and his final recommendation; and pre-purchase cash flow illustrations. *Id.* In addition, the district court noted that a strategy of capping policy loans at $50,000 and withdrawing only to basis was more consistent with Dow's purpose of producing cash flows to fund future retiree benefit expenses than a minimum-payment strategy because the capped-loan strategy produced higher positive cash flows after 18 years. *Id.* at 801-02. The capped-loan strategy was also more consistent with Dow's overall goal of tax avoidance than the minimum payment strategy because interest on loans above $50,000 was not tax deductible, and

withdrawing cash above basis would have exposed Dow to taxes that could have been avoided if that cash had been paid out as death benefits. *Id.*

A. Net Present Value (NPV) Analysis

The district court's conclusion that Dow's COLI plans had economic substance because they generated inside buildup was based, in part, upon the court's acceptance of the net present value (NPV) analysis of Dow's financial expert. That was a finding of fact, and I am satisfied the court did not commit legal error in accepting Dow's, rather than the government's, NPV analysis.

Courts have recognized that NPV analysis is an appropriate method to determine the economic effects of transactions designed to yield deferred returns. *ACM P'ship v. Comm'r*, 157 F.3d 231, 259 (3d Cir. 1998). NPV analysis consists of discounting future earnings by a factor intended to reflect the time value of money. *See Dow*, 250 F. Supp. 2d at 806. The discount rate used is the rate of return on an alternate investment.

The district court accepted the testimony of Dow's expert, Stewart Myers, who stated that the appropriate discount rate for the NPV analysis of Dow's delayed cash flows is an "after-tax" Moody's Corporate Average, which is calculated by multiplying Moody's Corporate Average by a factor of one minus Dow's tax rate. This adjusted discount rate reflects the reality that the death benefits from Dow's COLI plans were not taxable, whereas Dow would have to pay tax on the income from alternate investments. Dow's actual return from alternate investments would be reduced by its income tax rate, but its return from the COLI plans would not.

The government argues that, as a matter of law, the proper discount rate is an unadjusted Moody's Corporate Average because using a discount rate that reflects the tax-free nature of death benefits conflicts with the "pre-tax" analysis required by this circuit and the Third Circuit, and mistakenly puts Dow in a "world without taxes." *See AEP*, 326 F.3d at 743-44; *CM Holdings*, 301 F.3d at 95.

I do not agree with the government's argument that the "pre-tax" analysis required in this circuit under *AEP* requires an unadjusted discount rate. As the Third Circuit explained in *CM Holdings*, this "pre-tax" analysis requires only that there be removed from consideration the challenged deduction and the transaction be evaluated on its merits. *CM Holdings*, 301 F.3d at 105. It is not necessary, as the government suggests, that we must imagine a "world without taxes," and we may take into account the reality that some investments are tax favored.

Dow's expert separated Dow's COLI transactions into their investment and financing components or "legs" and analyzed the cash flows from each leg separately. The "investment leg" cash flows showed the benefits from inside buildup, whereas the "financing leg" cash flows showed the value added from financing—in this case, the interest deductions. The government does not claim that separating the investment and financing legs, as Dow's expert did, is not standard practice in financial analysis.

Dow's expert concluded that the investment leg of Dow's MetLife plan had an NPV of approximately $370 million and the investment leg of the Great West plan had an NPV of $76 million at the after-tax discount rate. By analyzing the investment leg separately, Dow's expert viewed the transaction as a whole—from beginning to end—but removed the challenged deduction from consideration as

AEP requires. By using an after-tax discount rate, he recognized the reality that corporations operate in a world with taxes and that some investments are tax favored. Since Dow's expert's analysis is a form of the "pre-tax" analysis required by this court in *AEP*, I am satisfied that the district court did not commit legal error by accepting Dow's expert's NPV analysis.

II. Mortality Gains

The second basis for the district court's determination that Dow's COLI plans had economic substance was its finding that, unlike the sham COLI plans, Dow's COLI plans transferred mortality risk to the insurers on the aggregate and therefore were not mortality neutral. There is no basis for concluding that this factual finding was clearly erroneous, and I disagree with my colleagues that the district court committed legal error in distinguishing the mortality features in Dow's COLI plans from those in *AEP* and *CM Holdings*.

This circuit in *AEP* and the Third Circuit in *CM Holdings* found that the plans in those cases were designed and operated to be "'mortality-neutral,' with neither side making money on the risk of employees dying early or late." *CM Holdings*, 301 F.3d at 104. "[T]he chance of mortality gains ever being enough to render the plan pre-tax profitable was essentially nonexistent." *Id.* Neither the taxpayer nor the insurance company was able to benefit from the timing of employee deaths because the insurance company paid the taxpayer "mortality dividends" if the cost of insurance exceeded death benefits and assessed COI surcharges if the taxpayer's death benefits exceeded actuarial projections. *AEP*, 326 F.3d at 740; *CM Holdings*, 301 F.3d at 104-05.

Although, as my colleagues point out, the insurance company in *CM Holdings* did pay out $1.3 million in

mortality gains in the early years of the plan, the Third Circuit found the plan was designed to eliminate retrospectively the taxpayer's ability to realize mortality gains because, "[r]ather than accept this loss as one that may sometimes occur no matter how carefully actuaries attempt to chart the vagaries of life and death, [the insurance company] assessed surcharges to recoup its losses and ensure mortality neutrality in the future." *CM Holdings*, 301 F.3d at 104-05. As the lower court in *CM Holdings* explained, although the insurer may never recoup the taxpayer's mortality gains, "this is a function of a policy contract provision capping maximum COI charges, not a function of risk shifting." *In re CM Holdings, Inc.*, 254 B.R. 578, 635 (D. Del. 2000).

The plan in *AEP* was also designed to eliminate retrospectively the taxpayer's ability to realize mortality gains. My colleagues selectively quote the advice received by the taxpayer to support their argument that the plan in *AEP* was not designed to provide a 100% adjustment. However, when that advice is quoted in its entirety, it supports the opposite conclusion:

> [A representative] advised AEP that "this mortality mechanism will result in a much closer match between expected cash flow from projected death benefits and claims that are actually paid. This will eliminate any volatility or variation in the cash flow that we are expecting in each year of the plan."

Am. Elec. Power, Inc. v. United States, 136 F. Supp. 2d 762, 777 (S.D. Ohio 2001) (citation omitted).

In contrast, the district court below found that Dow's COLI plans did not contain retroactive adjustment

mechanisms designed to eliminate the transfer of mortality risk by equating the COI with the death benefits paid. The district court found that the Great West plan paid Dow dividends to share favorable mortality experience, but those retrospective adjustments could not equalize COI and death benefits paid because Dow's plans were part of a pool of COLI plans that shared the mortality experience upon which the dividends were paid. *Dow*, 250 F. Supp. 2d at 808. The Great West plan also had an adjustment feature which increased the COI to account for prior unfavorable mortality experience, but that was a prospective measure "designed to fine tune the risk allocation going forward," not a retrospective measure designed to eliminate past risk transfer. *Id.* The MetLife plan also paid mortality dividends, but they did not transfer risk away from the insurance company, and benefitted only Dow. *Id.* at 810. MetLife also reserved the right to increase COI charges to recoup losses if mortality experience was unfavorable, but that right to adjust was limited by a stop-loss provision, which is common in group life insurance contracts. *Id.*

The district court concluded that Dow's COLI plans had features that were designed to reduce but not eliminate the mortality risk transferred to the insurers. The court found that Dow had the potential to realize substantial mortality gains, including catastrophic loss, which was a realistic possibility given that Dow's employees, unlike those in *Winn-Dixie*, were located in concentrated geographic areas. *See Winn-Dixie Stores, Inc. v. Comm'r*, 113 T.C. 254, 284-85 (1999). There is no basis for concluding that the district court's factual finding that Dow had the potential to realize mortality gains because its COLI plans transferred mortality risk to the insurers, on the aggregate, was clearly erroneous or that its conclusion that Dow's COLI plans were not mortality neutral was erroneous as a matter of law under *AEP*.

III. Subjective Business Purpose

A close study of Dow's COLI plans shows that Dow's plans were not the same as those found to be shams in *AEP*, *CM Holdings*, and *Winn-Dixie*, and that Dow did not enter into the plans for the sole purpose of tax avoidance. The sham COLI plans shared a number of features that indicated a sole purpose of tax avoidance. First, the taxpayers that operated those plans always chose the highest possible interest rates for their policy loans, or at least the highest rates they thought would pass IRS scrutiny. *See CM Holdings*, 301 F.3d at 100; *Winn-Dixie*, 254 F.3d at 1315; *Am. Elec.*, 136 F. Supp. 2d at 787. The choice of such high, commercially unreasonable rates was rational because those rates allowed the taxpayers to maximize their interest deductions without increased cost due to the fixed 1% spread between the loan interest rate and the credited rate on the policy value. In contrast, Dow chose a commercially reasonable interest rate for its policy loans based on Moody's Corporate Average, a typical and regulatory-favored rate for policy loans. *Dow*, 250 F. Supp. 2d at 813.

The sham COLI plans also offered loaned crediting rates that greatly exceeded their unloaned crediting rates. For example, in *CM Holdings*, the unloaned crediting rate was the greater of 4% or a rate declared by the insurance company, and the loaned crediting rate varied between approximately 9% and 13%; and the *Winn-Dixie* plan offered an unloaned crediting rate of 4% and a loaned crediting rate of 10.66%. *See CM Holdings*, 254 B.R. at 594-95, 606; *Winn-Dixie*, 113 T.C. at 281. These large differentials deviated from standard insurance industry practice and created a very strong incentive to continue taking policy loans throughout the life of the plan. *See CM Holdings*, 254 B.R. at 585-86. In contrast, there was a much smaller differential between Dow's MetLife unloaned and loaned

crediting rates, and Dow's Great West unloaned and loaned crediting rates were identical. *Dow*, 250 F. Supp. 2d at 778, 789. Dow's MetLife unloaned crediting rates were between 4% and 6.81%, and its loaned crediting rates were between 4% and 8.65%. *Id.* at 789. Dow also negotiated a higher unloaned crediting rate for the MetLife policies to begin in year 18. *Id.* at 809. Dow's unloaned and loaned crediting rate choices encouraged Dow to cap policy loans at $50,000 and invest cash into its COLI plans after the 17th year.

The taxpayers in *AEP*, *CM Holdings*, and *Winn-Dixie* also discontinued their plans after Congress passed the Health Insurance Portability and Accountability Act of 1996 (HIPAA) and phased out the interest deductions on COLI plans even though their proposed corporate purposes of funding retiree benefit expenses did not require cancellation of the plans. *See AEP*, 326 F.3d at 740; *CM Holdings*, 301 F.3d at 101; *Winn-Dixie*, 254 F.3d at 1315. In contrast, Dow stopped paying premiums on its MetLife policies, but otherwise kept its COLI plans intact after the passage of HIPAA. *Dow*, 250 F. Supp. 2d at 793-94. There is no reason to conclude that Dow's COLI plans lacked economic substance.

IV. Evidentiary Rulings

The majority opinion, given its treatment of the "economic substance" issue, does not address the government's argument that the district court abused its discretion in excluding Dow's IRS protest letters as "[e]vidence of conduct or statements made in compromise negotiations" under Fed. R. Evid. 408. Dow's IRS protest letters included cash-flow illustrations that did not show loans capped at $50,000. *Dow*, 250 F. Supp. 2d at 802.

The district court's factual finding that Dow submitted the protests in compromise negotiations is reviewed for clear error. *Trans Union Credit Info. Co. v. Associated Credit Servs., Inc.*, 805 F.2d 188, 192 (6th Cir. 1986). The court's ruling that the protests were inadmissible is reviewed for an abuse of discretion. *United States v. Logan*, 250 F.3d 350, 366 (6th Cir. 2001).

The government argues that Dow's protest letters were not "made in compromise negotiations" because they were filed with the IRS Examination Division rather than the Appeals Division, whose mission is to resolve tax controversies. *Dow*, 250 F. Supp. 2d at 803. It asserts that the Examination Division's investigation process is an adversarial one that involves determining whether the IRS erred. *Id.*

The district court found that, given the undisputed facts that large corporate taxpayers protest the vast majority of IRS disallowances and that the great majority of those protests are settled, Dow reasonably believed that it must first file a protest before it could reach the Appeals Division and compromise its claim. *Id.* at 805-06. Largely on this basis, the district court found that the protests were "made in compromise negotiations" and excluded them under Rule 408. *Id.* at 806. I am unable to conclude that the district court's factual finding regarding Dow's IRS protests was clearly erroneous.

Federal trial courts have wide discretion in determining whether to admit offers of settlement for "another purpose." District Judge David Lawson, the trial judge below, is a nationally recognized writer and lecturer in the Federal Rules of Evidence. He would have had in mind the policy objective of Rule 408 to "'weigh the need for such evidence against the potentiality of discouraging future

settlement negotiations.'" *See Trebor Sportswear Co. v. Limited Stores, Inc.*, 865 F.2d 506, 510 (2d Cir. 1989) (citation omitted).

The government also argues that Dow's protests should not have been excluded because they were being offered to impeach rather than to prove liability or damages. The district court found that there is little difference between using a statement to impeach the denial of liability and offering it to prove liability and therefore refused to apply the "another purpose" exception of Fed. R. Evid. 408 and admit the evidence. *Dow*, 250 F. Supp. 2d at 805.

I agree that using settlement evidence to impeach the denial of liability is virtually indistinguishable from using it to prove liability; both uses would equally discourage settlement negotiations. We do not review the district court's evidentiary ruling *de novo*, and I am satisfied the district judge did not abuse his discretion.

V. Conclusion

I respectfully dissent because I disagree with the majority's conclusion that, as a matter of law, future profits contingent on taxpayer action are relevant to the economic substance inquiry *only* when that action comports with the taxpayer's actual past conduct related to that particular transaction. I also disagree with my colleagues' conclusion that Dow's COLI plans were mortality neutral and that the district court erred in distinguishing the mortality features of Dow's COLI plans from those in the sham-COLI cases.

I would affirm the judgment in favor of Dow because I believe that the district court correctly applied this court's economic substance doctrine, did not commit legal error in accepting the NPV analysis of Dow's expert, did not abuse

its discretion in excluding Dow's protest letters from evidence, and did not commit clear error in making its central factual findings.

APPENDIX B

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
NORTHERN DIVISION

No. 00-10331-BC

THE DOW CHEMICAL COMPANY
AND SUBSIDIARIES,
Plaintiffs,

v.

UNITED STATES OF AMERICA,
Defendant.

OPINION

FILED IN THE U.S. DISTRICT COURT
EAST. DIST. MICH. BAY CITY
MARCH 31, 2003, 8:34 P.M.

HONORABLE DAVID M. LAWSON

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Dennis M. Donohue, Joseph A. Sergi, Alex E. Sadler, Washington, DC, James A. Brunson, Bay City, MI, Nicole M. Bielawski, Maggie O'Shaughnessy, Washington, DC, for defendant.

OPINION

Dow Chemical Company and its subsidiaries (Dow) have filed a complaint in this Court against the United States claiming that they are entitled to refunds for taxes paid for calendar/fiscal years 1989, 1990, and 1991, totaling $22,209,570, plus interest. The center of the dispute is the disallowance of deductions which Dow claimed for payment of interest on loans that were used to pay premiums on broad-based, corporate owned life insurance (COLI) policies purchased by Dow, and for administrative expenses associated with the purchase and maintenance of those insurance policies. In a very real sense, then, this case involves both death and taxes.

Dow purchased COLI policies on the lives of 4,051 of its upper management employees from Great West Life Assurance Company in 1988. In 1991, Dow purchased a group COLI policy on the lives of 17,061 employees from Metropolitan Life Insurance Company (MetLife). The premiums on these policies were financed by means of an elaborate plan to borrow from the insurer to pay premiums in the first three and eighth years of the policies. The loans were secured by the cash value of the policies. Premiums in years four through seven were paid by means of partial withdrawals of the accumulated cash value of the policies.

The policy acquisition plan thus drastically minimized the initial cash outlay for premium payments.

The United States claims that because the payment of the premiums and the loans and withdrawals occurred simultaneously on the first day of each policy anniversary, and were accomplished virtually or literally simultaneously by means of netting transactions, the transactions never actually occurred and constitute factual shams. The United States also asserts that the COLI plans had no practical economic purpose apart from generating the tax deductions for the interest payments and therefore are shams in substance. The government also contends that the Great West COLI plan does not constitute "life insurance" under Michigan law because Dow did not have an insurable interest in all of the 4,051 employees insured under that plan. Consequently, the argument goes, the plan fails to comport with Internal Revenue Code § 7702(a) and therefore Dow is not entitled to any of the tax advantages afforded life insurance, particularly the deferral of tax on the "inside build-up," and the interest paid on policy loans is not deductible under Internal Revenue Code § 161. Further, the government argues that the use of simultaneous netting transactions to finance the premiums by means of policy loans and withdrawals, which it believes are factual shams, causes the plan to fail the "four-of-seven" test set forth in Internal Revenue Code § 264(c)(1), and therefore, for that additional reason, interest deductions should be disallowed.

Many of these issues were thoroughly litigated in three prior cases, *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762 (S.D. Ohio 2001), *In re CM Holdings, Inc.*, *254* B.R. *578* (D. Del. 2000), *aff'd* 301 F.3d 96 (3d Cir. 2002), and *Winn-Dixie Stores, Inc. v. Commissioner of Internal Revenue*, 113 T.C. 254 (1999), in which the courts have found that the broad-based COLI

plans constituted shams in substance. The constellation of these cases has formed a lodestar which has guided and shaped the parties' presentation of evidence; the plaintiff has endeavored to demonstrate through testimony and exhibits that its COLI plans are substantially different from the plans condemned in the prior cases, while the defendant has attempted to show that the Great West and MetLife COLI plans are virtually identical, with nearly all of the offending features of the other plans in common.

Trial began on January 8, 2002, and the proofs concluded on March 12, 2002. The Court heard the testimony of 26 witnesses and received 1,526 exhibits. The parties filed a stipulation of facts consisting of 137 separate paragraphs. Initial and amended proposed findings of fact were filed, along with post-trial briefs. The parties then presented their final arguments in open court on May 28, 2002. The following constitutes the Court's findings of fact under Federal Rule of Civil Procedure 52, followed by its application of the governing law.

I. Background and Facts of the Case

A. Life Insurance General Terms and Features

In its most basic form, a life insurance contract consists of an agreement by an insurance company to pay a sum of money, known as a death benefit, to the beneficiary named on the insurance policy upon the death of the insured life. In consideration of the payment of a premium, the insurance company assumes the risk that the insured will die during a fixed period of time, usually one year. The premium charged for that year is calculated based upon data which includes the age of the insured, life expectancies of individuals of that same age, the likelihood that individuals of that age will die during that year, and the amount of the

death benefit. If there are no other features to the insurance contract, this kind of insurance coverage is known as term insurance or "pure insurance," and the charge associated with assuming the risk of premature death of the insured during that period is called the cost of insurance (COI). Because the likelihood of death increases as age advances, the COI for renewable term insurance becomes increasingly expensive as an insured grows older.

The insurance industry over the years has developed products that ameliorate the high cost of term insurance in the later years. "Whole life insurance" is a form of cash value insurance that is designed to provide coverage over the course of one's entire life, which is typically calculated at 95 years. A level, annual premium in excess of the cost of insurance is charged. The excess premium is invested by the insurance company so that the insurance policy accumulates "cash value," which consists of the accumulation of the excess premiums and earnings. The earnings are referred to as "inside build-up." If the insured dies, the cash value is paid out as part of the death benefit. As the insured advances in age, the cash value becomes an increasingly larger component of the total death benefit, and the pure insurance element correspondingly decreases, thereby moderating the COI.

In a typical whole life insurance policy, the annual premium is comprised of the COI, an excess amount which is invested for the purpose of accumulating cash value, charges for expenses such as policy administration and commissions, and a profit for the insurance company. The COI element of the premium is based in part on calculations using complex actuarial formulae which endeavor to quantify the risk of mortality of an insured in relation to a given population. Information concerning rates of death generally comes from statistical studies and compilations by

actuaries who assess the mortality experience of a given population. The results are assembled in mortality tables. In some circumstances, the actual mortality experience of an insurance company, that is, the frequency of the incidence of death among actual policy holders compared to the expected mortality of the comparator population, can determine the profitability of an insurance company. Another component of profitability comes from the performance of the insurance company's investment of excess premium. However, an insurance company may choose to share favorable mortality, expense, and investment experience with its policy holders by paying dividends when this experience outperforms expectations. Insurance policies which have this feature are known as participating (par) policies. Those without this feature are known as non-participating (non-par) contracts. Generally, in whole life policies the expense and pricing components of the premiums and, in par policies, dividends formulae, are not revealed to the policy holder.

In some cash value insurance policies, the policy holder has a contractual right to access the cash value. This may occur in the form of loans from the insurance company which are secured by the cash value of the policy. The insurance company charges interest, usually at a rate in excess of the rate of return paid on the investment principal of the contract. The rate of return on the investment portion of the insurance premium is known as the "credited rate." The amount of interest charged on the policy loan is known as the "loan rate." The difference between the loan rate and the credited rate is called the "spread," which can be established or adjusted to serve a variety of payment and financing goals. If an insured dies, a portion of the death benefit is used to pay off the loan and outstanding interest charges.

The policy holder may also access the cash value of the policy in certain insurance contracts by partial withdrawals, or "partial surrender," of the policy. Partial withdrawals need not be repaid, but there is a corresponding reduction in the death benefit of the policy.

When the cash value of the policy reaches a point where the return on investment covers the COI required to satisfy the death benefit along with the accumulated cash value and the expense of administration, the policy is considered "paid up" and no further premiums are due. Some policies are designed to require premium payments throughout the insured's "whole life," while others, such as the policies in this case, may compress the payments by requiring a larger premium for a lesser number of years for the same death benefit. Some par policies include a feature that dividends declared are used to purchase "paid-up additions" which increase the amount of the death benefit.

In the late 1970s, the insurance industry developed a "universal life" policy, which is a cash value policy in which all of the economic components are "unbundled," or revealed, to the policy holder. The development of universal life policies and the unbundling of economic components stimulated the development of different life insurance products that could address varying investment goals and returns for individual policy holders. For example, a younger individual who wants to purchase a maximum death benefit for a finite period of years may elect to purchase term insurance. Someone who wants a very low premium but permanent protection may elect to purchase a whole life insurance policy with limited borrowing features. A person who intends to use an insurance policy as a savings vehicle may elect to purchase a universal life policy which includes a partial withdrawal feature. An individual who wants to use his insurance policy as a source of funds may look for an

insurance contract which permits borrowing and partial withdrawals. The insurance industry has developed products over the years to accommodate all of these goals.

Insurance contracts are highly regulated at the state level, and the standard policies, or "forms," themselves are submitted to state regulators for approval. Policy forms may be approved as individual policies – i.e., contracts which insure a single life – or as group policies. Under a group policy form, a single policy can provide insurance on the lives of several individuals. Insurance provided to several employees as a benefit of employment frequently takes the form of a group contract, with the corporation owning the policy and the employees designating their respective beneficiaries. Some states, including Michigan, as will be explained later, limit the range of group insurance contracts in which corporations may be named as beneficiaries.

B. Tax Treatment of Life Insurance and Changes in Tax Law

It has been a long-standing feature of Congressional tax policy that the death benefit of insurance policies is not subject to income tax. *See* IRC § 72, 101(a). In addition, the inside build-up is tax deferred, and if paid out as a death benefit it is non-taxable. *See id.* Policy withdrawals are treated as coming first from basis and then from earnings, so withdrawals up to basis are likewise not taxable. *See id.*

The proceeds from loans secured by the cash value of insurance are, of course, not taxable since they do not constitute "income." See Internal Revenue Code (IRC) § 61 (not listing loan proceeds as gross income); *United* States *v. Ivey*, 414 F.2d 199, 202-03 (5th Cir. 1969). Furthermore, interest paid on these loans in the past has been tax deductible, although Congress has curtailed and ultimately

eliminated the interest deduction. In 1964, Congress amended IRC § 264 to limit interest deductions on loans used "to purchase or carry a life insurance . . . contract . . . pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract." Pub. L. 88-272 (1964); IRC § 264(a)(3). Deductions were still allowed where "no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness." IRC § 264(c)(1). In 1986, Congress once again amended section 264 to allow interest deductions only on the first $50,000 borrowed and secured by the cash value of a policy. *See* Pub. L. 99-514, § 1003, 100 Stat. 2085 (1986). Congress eventually eliminated the interest deduction altogether when it enacted the Health Insurance Portability and Accountability Act of 1996 (HIPA), Public Law No. 104-191, 110 Stat. 1936 (1996).

C. COLI in General

Traditionally, individuals purchased policies insuring their own lives naming other persons or entities as the beneficiaries designated to receive the death benefit upon the death of the insured policyholder. In earlier times, it was not uncommon for strangers to purchase insurance on the lives of prominent people, in effect wagering on the likelihood of their premature death. See *Crossman v. Amer. Ins. Co. of Newark, N.J.*, 198 Mich. 304, 308, 164 N.W. 428, 429 (1917). The concept of "insurable interest" arose to curb this disturbing trend. Generally speaking, an "insurable interest" is "a reasonable ground, founded upon the relations of the parties to each other, either pecuniary or of blood or affinity, to expect some benefit or advantage from the continuance of the life of the assured." *Warnock v. Davis,* 104 U.S. 775,

778-79 (1881) An individual is presumed to have an insurable interest in his or her own life. 3 *Couch on Insurance,* § 41.19 (1995). Likewise, it has long been recognized that corporations have an insurable interest in their important employees, supporting the development of so-called "key person" insurance in which a corporation purchases insurance on its employees' lives naming the corporation as the beneficiary. 3 *Couch on Insurance,* § 43.13. The death benefit provides economic protection against the untimely death of employees important to the success of the business. In these plans, the insured neither names the beneficiary nor owns the policy. Rather, it is "corporate owned."

Because of the favorable tax treatment of death benefits and inside build-up, corporate-owned life insurance on the lives of key employees was marketed and sold as an investment vehicle. Proceeds were commonly used to fund deferred compensation and other employee benefit plans. In addition, the industry developed plans to leverage the purchase of such insurance by borrowing from the insurance company, using the cash value of the policy as collateral, and using the loan proceeds to pay the annual premiums. Large cash value policies were marketed on the tax arbitrage opportunity based on the deductibility of policy loan interest. When Congress limited the interest deduction to policy loans of $50,000 or less, insurance entrepreneurs marketed COLI policies which insured a broader employee base, taking advantage of a national trend recognizing an employer's insurable interest in lower-level employees. Contributing to the desirability of these plans was the concept of "aggregate funding," i.e., using the cash generated by the policy or group of policies to fund entire programs, rather than simply tying the policy's death benefit to the benefit costs of a specific insured individual. In many circumstances, the financial success of these broad-based COLI plans relied on

the favorable tax treatment of cash value life insurance – that is, tax-exempt death benefits, tax deferral of inside build-up, and the deductibility of policy loan interest – rather than the economic gain solely from premature mortality of the insured employees.

In prior challenges to broad-based, highly leveraged COLI plans, the United States has not assailed the taxpayers' reliance on and utilization of tax benefits afforded by the treatment of death benefits and inside build-up. The broad-based COLI plans that have been under attack are those in which the government has argued that the taxpayer will derive no economic benefit from the plan absent the tax deductions on policy loan interest. In fact, it is the absence of the likelihood of profit from mortality and the stripping of cash value which has made those plans suspect and susceptible to the economic sham argument, as is described in the *AEP*, *CM*, and *Winn-Dixie* cases. The government claims that Dow's two COLI plans suffered the same infirmities.

D. The COLI Plans in AEP, CM Holdings and Winn-Dixie

The insurance policies involved in *Winn-Dixie, CM Holdings, and AEP,* were all characterized as highly leveraged, broad-based COLI plans, which combined large, front-loaded premiums and liberal access to quickly accumulating policy cash value. The cash from the policies accessed by a combination of loans and other distributions (partial withdrawals and dividends) was used to pay premiums and loan interest charges. The respective corporations owned the policies and were named as beneficiaries for the death benefits.

1. Winn-Dixie Stores, Inc., v. Commissioner of Internal Revenue

In *Winn-Dixie,* the taxpayer purchased insurance on the lives of nearly all of its 36,000 full- time employees. Annual premiums were charged in the amount of $3,000 per insured payable in years one through fifteen, with the amount of death benefit varying depending on the age of the insured. For the first three years, approximately 93% of the premium was paid by means of loans secured by policy cash value. Winn-Dixie elected an option in which interest was charged at a variable rate equal to Moody's high-risk bond average (Moody's BAA) instead of a lower fixed-term rate that was offered, and the borrowed cash value was credited with earnings at 40 basis points below the loan interest rate. This amounted to a 10.66% return on borrowed funds in the first year, yet the crediting rate on unborrowed funds was 4%. Based on pre-purchase 60-year projections, the Court found that Winn-Dixie would pay premiums and loan interest primarily through partial withdrawals of cash value in years four through seven, and then continue borrowing to pay loan interest throughout the remaining policy years. In the first four years, the amount of the premium actually paid in cash roughly approximated the insurance company's COI plus expense charges. The same projections demonstrated that the net pre-tax cash flow generated by the plan was a negative $682 million; however, when accounting for policy loan interest deductions and assuming a 38% tax bracket, Winn-Dixie would realize over $2 billion in positive cash flow over the life of the plan. The policies issued by AIG Life Insurance Company also contained a provision establishing a "claims stabilization reserve" which effectively limited the ability to profit from mortality charges. The policies allowed for partial withdrawals and borrowing up to net cash value, with the death benefit applied first to retire any outstanding policy loans. After the

passage of HIPA which eliminated tax deductions for COLI interest payments, Winn-Dixie cancelled its policies with AIG.

The Tax Court found that the loan and other premium-financing transactions "actually occurred," and therefore confined its analysis to whether the plan constituted a sham in substance. 113 T.C. at 278. In examining the overall transaction, the Court concluded that since there was no reasonable basis for Winn-Dixie to expect to profit from death benefits due to the ameliorating effect of the claim stabilization reserve, and policy cash value was relatively small throughout the projected life of the plan, the deduction of policy loan interest payments was "clearly the dominant element" of the plan. *Id.* at 281. Without the benefit of interest deductions, the plan yielded substantial negative cash flow in each of the sixty years. The plan was economically viable only as long as Winn-Dixie's "appetite for interest deductions remains large," and tax considerations "permeated" the pre-purchase analyses. *Id.* at 288. Finding that consistent pre-tax negative cash flow "precludes any economic value, economic significance, economic substance, or commercial substance other than the tax benefit," the Court concluded that the plan was a sham in substance. *Id.* at 290.

2. In re CM Holdings, Inc.

In *CM Holdings,* the COLI policies were "designed to be owned on a broad base of employees, to be financed through a highly leveraged transaction, and had to provide the policyholder with a positive cash flow in every year of the policy." *CM Holdings,* 254 B.R. at 582-82. The COLI policies, known as the "COLI VIII Plan," were issued by Mutual Benefit Life Insurance Company (MBL) to Camelot Music, Inc., a wholly owned subsidiary of CM Holdings, and

carried a fixed annual premium of $10,000 payable in years one through nine for each of the policies purchased on 1,431 employees (one policy was later rescinded). The death benefits increased over time, varied based on the issue age of the policies on each individual insured, and the policies had several cash-access and transparency features of universal life policies. Camelot paid $1 million of the $14 million in cash for the first-year premium. The balance of the premium, or approximately 93%, was paid by policy loans. Camelot financed the second and third year premiums and accumulated loan interest charges in the same fashion.

Camelot continued to take policy loans in the second and third years to pay approximately 90% of the annual premiums. *Id.* at *593.* The other 10% of the annual premiums was paid in cash. *Id.* at *593.* The policy loan interest in these years was paid by taking additional policy loans. *Id.* at 607. The premium payment and loans occurred in simultaneous netting transactions in which the amount of the policy loan was deducted from the gross premium, the payment of which was the basis for the cash value which secured the loan. The amount of the premium which Camelot elected was designed to create first-day, first-year cash value that earned interest at the crediting rate, which Camelot elected to be indexed to Moody's BAA enhanced rate. This election in turn determined the policy loan interest rate, because Camelot chose a variable rate calculated at 100 basis points above the crediting rate for borrowed funds.

Customarily in cash value policies, the annual premium less an expense charge and the COI is added to the policy's cash value. The expense charge is a percentage of the premium set aside to cover commissions and other administrative costs, and may include a "margin" which is intended as a hedge against higher than anticipated costs. The expense charge is typically between 5% and 8% of the

annual premium, including the margin which is intended to reasonably relate to the risk that higher than anticipated charges will materialize. In *CM Holdings,* the annual premiums and loan interest payments in years four through seven were financed by cash, partial withdrawals, and a device called a "loading dividend." *Id.* at *593.* By design, 95% of the gross premium was taken as an expense charge, known as the "loading charge." *Id.* at *593.* In actuality, the expenses were between 5% and 8% of the gross premium. *Id.* at 593. The difference between the "loading charge" and MBL's actual expense charges generated excess funds in the policies which resulted in the payment of a "loading dividend," which amounted to about 92% to 95% of the loading charge. *Id.* at 594. In simultaneous netting transactions, the loading dividend was used to pay the premium. *Id.* at 593. A partial withdrawal was taken in an amount equal to about 99% of the policy loan interest payment and used to make that payment. *Id.* at 593. The Camelot COLI VIII policies did not limit the amount of policy value that could be taken as a partial withdrawal. *Id.* at 594. Camelot paid the balance of premiums (about 5%) and loan interest payment (about 1%) in cash. *Id.* at 593.

Although Camelot originally planned to take policy loans in years eight and nine, those loans were never taken. *Id.* at 592 n.16. During the first eight years, $31.3 million in policy loan interest accrued. *Id.* at 607. Camelot paid $12 million, or about 40% of the policy loan interest, in cash. *Id.* at 607.

Cash value was stripped from the Camelot COLI VIII policies by means of a highly efficient computer program designed to achieve zero net equity on the last day of each policy year, *id.* at 595, such that the net equity of the policies "would not exceed one penny." *Id.* at 631. Moreover, the

Camelot COLI VIII plans were designed to be "mortality neutral." This meant that the

> cumulative COI charge paid by Camelot was anticipated to equal the cumulative death benefit that would be distributed to Camelot, with the exception of a profit margin to the insurance company of 20% of the COI charge in the first plan year, 10% in the second plan year, and 2% thereafter.

Id. at 632-33 (footnote omitted). Although so designed, the Camelot COLI VIII plan did not operate in a mortality neutral way. *Id.* at 633. Over the first seven years, Camelot received death benefits and mortality dividends $1.3 million higher than its COI. *Id.* at 633-34. This was the result of pooled dividends in the first three policy years and a combination of pooled and experience-rated dividends in the fifth policy year; the experience-rated dividend was totaled only $293, all received in the fifth policy year. *Id.* at 634-35. In that fifth policy year, the Camelot COLI VIII plan moved to an experience-rated approach. MBL explained that

> [t]he new mortality mechanism will result in a much closer match between the expected cash flow from projected death benefits and claims that are actually paid. This will minimize any volatility or variation in the cash flows and corporate earnings which are expected in each year of the plan.

Id. at 635.

With the passage of HIPA in 1996, Camelot stopped paying premiums and allowed the policies to function as

paid-up policies for a reduced amount of death benefit coverage. *Id.* at 641. This resulted in a $30 million reduction in death benefits causing a $30 million partial withdrawal which forced all of Camelot's taxable policy gain out of the policies. *Id.* at 641.

Albeit cleverly designed, the COLI VIII plan ran afoul of the governing case law concerning so-called "shams in fact" and "shams in substance," according to the district court. *Id.* at 598. Although the policy loans used in the first three years and the interest accrued on them were found to possess factual substance, the loading dividends used in years four through seven of COLI VIII did not fare so well. In order to calculate the dividend amounts, the policies charged administrative fees considerably out of proportion to the actual costs incurred. Furthermore, instead of distributing the dividend from accumulated surplus, the policies "sourced" their dividends from excessive loading charges which were instantaneously offset against payment of the premium. The lack of any contributions to the dividends from investment yields was also suspicious. The district court was also troubled by the payment of the dividends at the beginning of the policy year, rather than the industry-standard practice of paying at the end of the year. The legitimacy of the dividends was further compromised by the fact that they were guaranteed, not contingent. Topping it off, the designers of the COLI plan did not treat the dividends as a liability on its balance sheets. The combination of all these factors provided "overwhelming evidence" to the district court that the loading dividends were factual shams. *Id.* at 617-20.[1]

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[1] It is worth noting that the Third Circuit disagreed with this finding on appeal, although it did affirm the judgment on the basis that the policies were nevertheless shams in substance. *In re CM Holdings,* 301 F.3d 96 (3d Cir. 2002). Although the nature of the loading dividends – made contrary to industry practice – provided evidence that the dividends

The district court further concluded that the COLI plan, as a whole, was a sham in substance that lacked any rational economic purpose other than the creation of tax savings through interest-payment deductions. The court's determination centered on two factors: "the objective economic substance of the transactions and the subjective business motivation behind them." *Id.* at 621 (citation and internal quotation marks omitted). From the objective standpoint, all of the pre-purchase illustrations projected Camelot's cash flows to be negative absent the interest deductions in all years of the plan and in the aggregate. In addition, projections considered by the court, when discounted to present value, made it clear that the plans generated negative cash flow absent the interest deductions and positive cash flow only when those deductions were considered. This conclusion was bolstered by the economic neutrality of the plans, which were designed to preclude any cash build-up in the policies. Rather, any value received was immediately stripped from the policies in the form of loans or dividends. Similarly, the policies' focus on "mortality neutrality" meant that there was no risk involved for either party with respect to the disbursement of death benefits, unlike traditional insurance contracts. *Id.* at 637.

Camelot's subjective intent in adopting the COLI plan did not salvage the transactions. Although the court saw no reason to discredit Camelot's explanation that it purchased the COLI policies to offset the cost of medical benefits, that alone was not sufficient to confer economic substance on what was otherwise an "economically empty

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were part of a larger *substantive* sham, the Court concluded that the circular netting transactions culminating in loading dividends were no less real than the circular netting transactions culminating in policy loans that the district court approved. *Id.* at 108. Because in both cases the transactions "actually occurred," they could not be considered factual shams. *Id.* (citation omitted).

transaction." *Id.* at 638. Camelot's position was also undermined by evidence indicating that the interest deductions played a crucial role in convincing Camelot to purchase the policies, and by management's awareness prior to purchase that the policies could not be profitable on a pre-tax basis. *Id.* at 639-41.

The district court further concluded that Camelot could not save the deductions taken in years one through three via the four-of-seven safe harbor provided by I.R.C. § 264(c)(1), which permits deductions on policy loans taken from life insurance policies as long as "no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium. . . was paid) is paid under such plan by means of indebtedness." 26 U.S.C. § 264(c)(1). The court concluded without contest by the policyholder that the statute implied that the premiums paid must be level throughout the seven-year period. *Id.* at 645. Once the court deducted the portions of those premiums that were "paid" by loading dividends, the remaining amounts actually paid were substantially lower that those paid in previous years with the aid of the policy loans (which were found not to be factual shams). The result was that the effective amount of the premiums paid was not truly level throughout the first seven years of the policy, and the taxpayer could not take advantage of the safe harbor of Section 264(a)(2), which otherwise precludes deductions for premium financing arising from a corporate life insurance plan "which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value" of the policy. Having violated the implicit requirement that premiums remain level, the interest deductions taken for the first three years of the policies were also invalid. *Id.* at 646-47.

3. American Electric Power, Inc. v. United States

The COLI plan at issue in *AEP* was almost identical to the one considered in *CM Holdings*. *See AEP*, 136 F. Supp. 2d at 768-69. In that case, the plaintiff, American Electric Power Company, purchased COLI policies on its employees' lives intending to offset the effect on its earnings reports of new accounting requirements for expensing post-retirement medical benefit obligations. Although the death benefit of each policy varied according to the age of the employee, the other terms were identical. *Id.* at 774. Each policy in the plan provided fixed, annual premiums of $16,667 that were designed to permit the accumulation of $50,000 in cash value within three years.

Over the first three years, AEP would pay approximately ninety percent of the premiums through policy loans "in simultaneous netting transactions in which the loans were offset against the premiums." *Id.* at 776. This structure allowed AEP to pay approximately $23.5 million in cash, including administration fees, for premiums costing $330 million. That $23.5 million, in turn, would be offset by deductions for interest paid on the policy loans and the receipt of tax-free disbursements in the amount of $10.8 million. AEP thus ended up with $3.5 million of *positive* cash flow in the plan's first year, rising to $3.9 million in the second year, $10.5 million in the third year, and more than $35 million after eight years. *Id.*

After the third policy year, borrowings to pay premiums approached the $50,000 policy loan limit of I.R.C. § 264, so premium payments and accrued loan interest were paid using dividends and partial withdrawals in simultaneous netting transactions once per year. Ninety-five percent of each premium was considered an expense charge by the insurer, and the remainder was returned to AEP as a "loading

dividend." *Id.* No premiums were due from that point forward, although the policy loans remained outstanding and generated more than $100 million of interest expense each year, offset by cash withdrawals which stripped excess cash from the policies, resulting in zero net equity. Through year 20, positive cash flows of $35 million to $39 million were projected, after the tax deductions were taken into account.

In addition, the court found that these policies were "mortality neutral," since there was no risk to either party that the amount of death benefit paid would vary from the COI. This was achieved by means of an annual dividend that would refund excess monies after any year that morality "prove[d] more favorable to the [insurance] company than expected." *AEP*, 136 F. Supp. 2d at 777.

The net effect of these structures was to create a scheme in which policy payouts would exactly offset the premiums paid less a fixed profit for the insurer. The *AEP* Court agreed with the *CM Holdings* Court that this design was problematic. First, although the Court agreed that the loading dividends in years four through seven could be workable, the mortality neutral design of the COLI scheme eliminated any "reasonable relationship to the insurance company's risk of incurring higher than expected expenses." *Id.* at 782. Second, the *AEP* court agreed with *CM Holdings* that the Code's "four-of-seven" rule required the premiums to be level in all events. Third, the AEP COLI plan as a whole was an economic sham because its neutrality on mortality and absence of excess cash in the policy gave it no "practicable economic effect other than the creation of income tax losses." *Id.* at 785 (quoting *Rose v. Comm'r*, 868 F.2d 851, 853 (6th Cir. 1989)).

Finally, although the court determined that simultaneously borrowing against the policy and paying that

year's premiums with those loan proceeds was not a factual sham, the first-year loans were suspiciously backdated in a manner inconsistent with industry practice. When AEP decided to participate in the Mutual Benefit Life Insurance (MBL) COLI VIII plan, it signed prepayment agreements on February 16, 1990 that allowed AEP to purchase COLI on its employees between that date and the date the policies were finally issued. The policies were issued on March 23, 1990, and MBL originally calculated March 23, 1990 as the inception date for the policies. Because using the March date cost it almost $2 million in deductions, AEP complained, and Integrated Administration Services (IAS), which was administering the program for MBL, responded by backdating the inception date to February 16, 1990, when the prepayment agreements were signed. The Court found this to create a sham in fact with respect to interest "accrued" between February 16 and March 23, 1990 because loans were never issued during the prepayment period, and AEP paid no interest during that time. Furthermore, since the policies were considered to have been issued to a grantor's trust on March 21, 1990, the trust became liable for debt that predated its existence. *Id.* at 781-82. The court brushed off, with little explanation, AEP's contention that these sort of "bridge" agreements were common in the life insurance industry for applicants who wanted to be protected while the policy was being considered and processed:

> While there was evidence presented showing that it is common in the life insurance industry to issue a conditional receipt at the time of taking an application for life insurance and to provide death benefit coverage from the date of the receipt – after it has been determined that the insured meets the company's underwriting requirements – there was no evidence presented of a custom or practice to

> backdate policy loans in the manner in which it was done in the instant case. The court concludes that the manner in which IAS originally intended to calculate the first-year policy loan interest is more likely the industry norm for a transaction of this kind.

Id. at 782.

Thus, in these three cases, the courts generally determined that the COLI plans constituted economic shams, functioning only as interest-deduction engines that drove no legitimate financial vehicles. The courts pointed to artificially high loan interest rates which had no practical adverse effect on the borrower because the fixed spread correspondingly drove up the supercharged credited rate on borrowed funds; relatively small interest rates on unborrowed funds to discourage leaving cash in the policies; the elimination of mortality risk by means of fully retrospective, annual equalization of COI and death benefit payments; the use of unconventional "loading dividends" as a means of paying premiums in four of the first seven years; an exquisitely efficient computer program which stripped virtually all equity from the policies year after year; and prepurchase illustrations which showed only negative cash flows without the tax deductions in each of the policy years through the duration of the programs. These courts concluded that there could be no profit on premature mortality because of the retrospective adjustment which eliminated mortality risk in advance, and no return on inside build-up because all the cash was stripped from the policies throughout the program.

As will be explained in greater detail below, the COLI plans purchased by Dow were similar, although not identical to, the COLI plans in the cases described above.

They all involved cash value policies that compressed the premium payments into a relatively short period, they called for a highly-leveraged premium financing strategy that avoided policy loans in years four through seven, they all carefully monitored the relationship between COI and the actual death benefit payout, and they all were used to fund in the aggregate future corporate benefit obligations. There are critical differences in Dow's plans, however, which preclude finding that the plans are factual shams. The Court concludes that there was an economic benefit that potentially could be derived from the plans without relying solely on the tax deductions for policy loan interest. As will be explained, Dow articulated a legitimate purpose for embarking on the programs: providing a source of cash to cover unfunded future medical obligations for its retirees. Dow had turned to similar devices in the past, albeit on a much smaller scale, to cover contingent liabilities.

E. Dow's 1983 and 1985 COLI Policies

In 1983, Dow purchased 89 COLI policies from Connecticut General Life Insurance Company (CIGNA). Stip., ¶ 28. Purchased on senior executive-level employees, including Dow's President, its Chief Executive Officer, its Executive Vice Presidents, and a number of Senior Directors, the policies, dated December 1983, were intended to provide a funding source for deferred compensation obligations Dow had to those employees. Stip., ¶ 28. These policies were purchased to protect Dow from financial damage in the event of loss of its key employees' unique knowledge and expertise and to offset unfunded liabilities that Dow had to the insured employees. Pierce, Tr. at 4276, 4328. The premiums and death benefit varied for each policy according to the salary level of the insured employee. Pierce, Tr. at 4278-80; Ex. D970. Dow paid the annual premiums for the first, fifth, sixth, and seventh policy years

in cash; annual premiums for the second, third, and fourth policy years were paid using policy loans. Pierce, Tr. at 4281; Ex. D970. Neither first-day, first-year policy loans nor partial withdrawals were taken with these policies. Pierce, Tr. at 4281; Ex. D970. These policies were acquired and subsequently monitored by Dow's Human Resources department. Falla, Tr. (1/9 a.m.), at 32-33. In 1988, Clark/Bardes, Inc. (Clark/Bardes), a broker, took over administrative support for the CIGNA policies. Stip., ¶ 29.

In 1986, Dow purchased 52 COLI policies from Great West Life Assurance Company (Great-West). Stip., ¶ 30. These policies, dated November 10, 1985, were purchased on senior executive-level employees to offset Dow's unfunded deferred compensation liabilities to those employees. Stip., ¶ 30; Pierce, Tr. at 4334; White, Tr. (1/10 a.m.), at 12. These policies were individual, traditional, participating, whole-life, paid-up-at-age-95 base policies with an attached rider. Ex. P91. Level annual premiums were payable at issue and continued until age 95. *Ibid.* Like the 1983 COLI program, the annual premiums and death benefit on the 1985 COLI policies varied according to the salary level of the insured employee. Pierce, Tr. at 4285-87; Ex. J 1191. Dow paid the annual premiums for four out of the first seven policy years in cash; annual premiums for the other three policy years were paid using policy loans. Pierce, Tr. at 4281. Neither first-day, first-year policy loans nor partial withdrawals were taken with these policies. *Id.* at 4292. The purchase of these policies was again handled by Human Resources; however, Clark/Bardes provided the administrative support for the management of the policies. Stip., ¶ 31.

Both the 1983 CIGNA and apparently the 1985 Great-West COLI policies provided for a variable loan interest rate based on Moody's Corporate Average. Ex. J11;

Ex. P91. Moody's Corporate Average is a long-term index which approximates the rate of return earned on assets invested by insurance companies. By charging interest at the Moody's Corporate Average rate, an insurer avoids discrimination between its borrowing and non-borrowing policyholders and protects the insurance company from the risk of disintermediation, that is, the risk that a policyholder will borrow cash from the insurance policy at below market rates when returns on investments are considerably higher than the policy loan rate. Todd, Tr. at 636-37; Puglisi, Tr. at 5276-77, 5278; DesRochers, Tr. at 35970-98, 3599; Hoag, Tr. at 6205-06. Also, by using Moody's Corporate Average as a borrowing rate for policy loans, an insurance company decreases the sensitivity of the insurance company's financial statements to policyholder borrowing. Plotkin, Tr. at 4085-86; DesRochers, Tr. at 3598.

The cash flows generated by the 1983 and 1985 COLI programs were not segregated as specific pools of funds for the purpose of offsetting Dow's unfunded liabilities to the employees insured; rather, the cash flows generated were fungible and could have been used for any corporate purpose. Pierce, Tr. at 4328, 4334. Dow's interest deductions relating to the 1983 CIGNA and 1985 Great-West COLI policies were not challenged by the IRS. Pierce, Tr. at 4335.

F. Dow's Purchase of the Great West COLI Policies

1. Dow's Business Purpose: Mounting Employee Retirement Medical Expenses

The 1983 and 1985 COLI programs were purchased to fund deferred compensation obligations. In 1982, Dow retained an outside consulting firm, Watson Wyatt Worldwide (Wyatt), to calculate the present value costs of its

future liabilities for retiree benefits and the annual contribution required to fund those benefits. Ex. J7; J9; Falla, Tr. (1/8 a.m.) at 121. For each dollar Dow pays an average employee in salary, it pays that employee an additional 22 to 25 cents in benefits. Falla, Tr. (1/18 a.m.) at 115. The estimated present value of Dow's accrued post-retirement life and medical plan liabilities in 1983 was approximately $500 million. Ex. J9; Pierce, Tr. at 4336. The estimated liabilities rose to over $1 billion by 1987. Ex. J73. The increase was the result of the escalating cost of benefits and the significant increase in the utilization of medical, health, and life insurance benefits. Falla, Tr. (1/8 a.m.) at 117, 123; Lake, Tr. (1/10 p.m.) at 85. Dow executives worried that Dow might no longer be able to offer post-retirement benefits to its employees unless it found a way to fund these costs. White, Tr. (1/10 a.m.) at 65.

In 1983, Wyatt assigned Gary Lake as Dow's actuarial consultant. Lake, a member of the American Academy of Actuaries since 1977, started at Wyatt in 1973 and became its national resource on COLI-related matters, advising approximately fifty clients. As Dow's actuarial consultant, Lake assisted Dow in evaluating whether COLI was a viable means for funding the employee benefit obligations identified, educated Dow as to insurance products and risks inherent in COLI, and helped develop specifications to solicit and compare bidder's proposals. Lake, Tr. (1/10 p.m.) at 73-74, 78. Lake advised Dow on its purchase of all its COLI programs: the 1983 CIGNA and 1985 Great-West, as well as the two COLI programs in this case.

2. Changes in Accounting Requirements for Retiree Medical Expenses

Prior to 1989, Dow accounted for its retiree medical benefits on a pay-as-you-go basis. Falla, Tr. (1/8 a.m.) at 116-17; Brink, Tr. at 2398-99. In February 1989, the Financial Accounting Standards Board (FASB) issued Exposure Draft 105, Employer's Accounting for Post Retirement Benefits Other than Pensions. If implemented, this document would have required employers to accrue current liabilities for retiree medical and life insurance benefits on a current basis for the purpose of their financial statements. Stip., ¶ 32; Lake, Tr. (1/10 p.m.) at 81. Exposure Draft 105 would have required Dow to accrue $1.6 billion as the present value of its accrued retiree medical liabilities in 1989. Stip., ¶ 33. In December 1990, the FASB issued FASB Statement No. 106 (FAS 106), Employer's Accounting for Post-Retirement Benefits Other than Pensions. FAS 106 adopted the requirements of Exposure Draft 105, effective for fiscal years beginning after December 15, 1992. Stip., ¶ 34. A 1991 calculation placed Dow's accrued retiree medical liabilities at $1.34 billion. Ex. J411.

Dow adopted FAS 106 effective January 1, 1992. Stip., ¶ 35. In making the transition to this accounting standard, Dow took an after-tax charge of $994 million against its 1992 income for unfunded retiree obligations with a net present value of $1.45 billion accrued to date. Ex. J641. The liability continued to grow. Ex. J722 ($1.54 billion in 1993); Ex. J774 ($1.62 billion on January 1, 1994).

3. Requests for Proposals (RFP)

Dow officials decided to explore COLI as a means of funding these liabilities and, as before, turned to Gary Lake

for advice. The "kick-off" date for the exploratory project, as Lake referred to it, was April 1, 1987. Because the Human Resources Department acquired Dow's other COLI policies, Loren Pierce, Dow's Manager of Executive and International Benefits at the time, was approached by Clark/Bardes about a new version of corporate-owned life insurance on the market, known as "COLI III," to fund various employee benefit liabilities. Ex. J12; Ex. J14; Pierce, Tr. at 4303-04. In April 1987, Dow, assisted by Lake, initiated a review of COLI as a potential funding vehicle for Dow's post-retirement liabilities. Ex. J58; Lake, Tr. (1/14 a.m.) at 5.

On May 28, 1987, Pierce wrote a memo inviting various Dow employees to a presentation on COLI III, noting that "COLI III is a significantly different product than we have previously seen and is becoming more of an investment than benefit funding mechanism; thus we thought more financial people should hear about it." Ex. P5; Falla, Tr. (1/8 a.m.) at 137-40. The proposed transactions involved large and complex financial issues, but also addressed liabilities with which Human Resources was familiar. Nevertheless, because COLI was described as more of an investment than a benefit funding mechanism, Pierce contacted representatives from Dow's Treasury Department. Ex. P5; Falla, Tr. (1/8 a.m.) at 140; Pierce, Tr. at 4337-39.

That spring, Lake conducted a two-step evaluation of COLI for Dow. In step one, he evaluated Dow's accrued post-retirement benefit liabilities; in step two, he helped Dow evaluate COLI as a potential funding vehicle for the liabilities. Ex. J55; Ex. J60; Lake, Tr. (1/10 p.m.) at 92. Lake made a side-by-side comparison of the net present value of the benefit liabilities and the projected after-tax cash flows of a COLI program, even though this was not necessary because the benefit liabilities far exceeded the

projected earnings. Lake, Tr. (1/10 p.m.) at 93; Lake, Tr. (1/14 a.m.) at 15-16.

Between June 12 and August 25, 1987, Dow employees heard three presentations on COLI III. The June 12, 1987 presentation by Clark/Bardes detailed the then-recent amendment to I.R.C. § 264 which limited interest deductions to $50,000 of policy loans per employee. Ex. J65. The participants at the meeting also discussed future tax law changes, likely insurance carriers for Dow to consider, and issues to consider in the decision-making process. Ex. J65.

On August 4, 1987, a representative for Management Compensation Group (MCG), a broker, gave a presentation regarding a COLI product offered by Mutual Benefit Life. Ex. J71. After this presentation, Dow representatives made two decisions:

> 1) Proceed with COLI for [approximately] 1200 employees in the MIP [Management Incentive Program]. This will likely be done through Clark Bardes with Conn. Mutual since forms that were signed by employees contemplate this.
>
> 2) The new COLI concept with MCG will be investigated for up to 4 or 5,000 additional employees strictly as an investment vehicle to take advantage of the tax arbitrage.

Ex. J71, at A011224; Stip., ¶ 69.

On August 25, 1987, representatives from Clark/Bardes made a presentation regarding a proposal for a Connecticut Mutual COLI plan covering approximately

1,200 Dow employees. The Connecticut Mutual COLI product would offer a guaranteed dividend formula, guaranteed mortality, and a 75-basis-point spread with the "[g]ain to Dow com[ing] from tax leverage." Ex. J75, Bates A011212; Burdett, Tr. at 1492-93. As noted above, the "spread" is the difference between the interest rate earned by Dow on the money in the policy (i.e., the credited rate) and the interest rate charged to Dow on loans taken (i.e., the loan rate).

The next day, the COLI Task Force was formed by Enrique Falla, Dow's Chief Financial Officer, and Jay Hornsby, head of Human Resources. Falla, Tr. (1/8 a.m.) at 142. The COLI Task Force was chaired by Glenn White, director of taxes and *ex-officio* member of the finance committee. *Id.* at 142-43. The other members were Anita Jenkins, an attorney who worked in the tax department on benefits issues; William Wales and Janet VanAlsten, attorneys assigned to work with the human resources department; Pierce; Bill Schmidt, assistant comptroller; and Howard Burdett, assistant treasurer. Stip., ¶ 70. Falla provided the Task Force members a "road map" of issues to be addressed before proceeding with a transaction, consisting of: (1) tax issues, including concerns with the then-current law and with prospective legislative changes to that law; (2) legal issues, including the question of insurable interest; and (3) financial issues. Ex. J76; Ex. J77. The COLI Task Force issued a report on September 8, 1987. The report indicated that "[COLI] is a program that the corporation may find suitable for providing funding for employee benefit plans or perhaps for other general revenue purposes." Ex. J1218. According to Falla, the "general revenue purposes" language was used to give Dow a "little latitude in the event [it] want[s] to modify a program." Falla, Tr. (1/8 a.m.) at 157.

a. Dow's pre-purchase analysis of tax issues

In examining the tax issues, the tax force recognized that there are three tax benefits generally available through the corporate use of leveraged cash value life insurance: (1) the tax-free build-up of the cash value; (2) the tax-free payout of death benefits; and (3) the deductibility of interest up to a $50,000 loan cap. The defendant's experts acknowledged that corporations like Dow should take full advantage of the tax laws to minimize their tax liability and maximize shareholder wealth. Puglisi, Tr. at 5311, 5312; Hoag, Tr. at 6409-10, 6411, 6414, 6356. Dow's Tax Department, with the assistance of Lake, researched and resolved several tax issues prior to Dow's purchases of its 1988 and 1991 COLI, including evaluating Dow's options for unwind scenarios if the tax law changed. White, Tr. (1/10 a.m.) at 13, 20-21; Jenkins, Tr. at 462021; J67. On August 10, 1987, Jenkins authored a memorandum to White identifying potential tax issues concerning COLI, including: (1) the qualification of the policy as real life insurance under Code Section 7702, and (2) the use of financing mechanisms to pay premiums in years four through seven as potentially violative of Section 264. Ex. J72 at H00229-H00231; Jenkins, Tr. at 4535-37. White followed up on Jenkins's memorandum with a memorandum to Enrique Falla on August 25, 1987. He identified for Falla the primary tax exposure risks of COLI as outlined in Jenkins's August 10 memorandum. White also noted that Dow should incorporate a suitable cancellation provision in the contract in case Congress enacted legislation curtailing the tax benefits of COLI. Ex. J76; White, Tr. (1/10 a.m.) at 1516.

On October 22, 1987, Jenkins again identified the Tax Department's concerns regarding the design of COLI policies, advising that if Dow were to proceed with the purchase of COLI, then several conditions had to be met,

including: (1) satisfaction of Code Section 264 by avoiding characterization as a single premium policy and complying with the so-called "four-out-of-seven" safe harbor; and (2) satisfaction of the requirements of Code Section 7702, including qualification as insurance under state law. Ex. J124; Jenkins, Tr. 4531-35; White, Tr. (1/10 a.m.) at 31. Gary Lake likewise identified as risks (1) the use of partial withdrawals or loading dividends to finance premiums in years four through seven under Section 264; (2) the definition of life insurance under Section 7702; and (3) the risks of sham transaction characterizations resulting from aggressive policy features such as policy loan rates above Moody's Corporate Average and the use of arbitrary dividend payments to minimize cash flow. Ex. J60; Ex. J67 at A011245.

Ultimately, White, Lake, and the COLI Task Force were satisfied that they had resolved all of their issues favorably. White, Tr. (1/10 a.m.) at 70-71, 73-77. Dow planned to use partial withdrawals instead of loading dividends to pay premiums in years four through seven. Lake, Tr. (1/14 a.m.) at 20-21, 92-93. Dow representatives were never comfortable with the use of unconventional "loading dividends" for that purpose. With respect to Section 7702, Lake provided actuarial verification that the COLI programs Dow considered satisfied the alternative mathematical tests of that section. Lake, Tr. (1/14 a.m.) at 14. Dow decided that the Great-West policies were not subject to Section 7702A. DesRochers, Tr. at 3564-65. As for financing premiums with policy loans, Dow rejected the use of enhanced policy loan interest rates and instead selected Moody's Corporate Average as an appropriate policy loan interest rate. According to Lake, Dow's selection of Moody's Corporate Average reflected Dow's desire to be on the "conservative side" of the policy loan feature. Lake, Tr. (1/14 a.m.) at 19, 59-60; White, (1/10

a.m.) Tr. at 36-38. On mortality issues, Dow and Lake determined that a COLI product that trued up COI charges based on actual mortality at the end of each policy year (i.e., a product that was 100% experience-rated) would violate the requirement that an insurance policy transfer risk to the insurer. Lake, Tr. (1/14 a.m.) at 124, 135. Although Dow and Lake wanted to reflect Dow's favorable mortality experience in the mortality charges, Dow wanted to avoid a 100% experience-rated policy. Dow also was mindful of the shifting landscape in tax legislation impacting COLI; the Task Force considered the possibility of legislative action that would diminish various tax advantages of COLI, particularly the tax-free character of the inside build-up and the deductibility of policy loan interest. J77 at A011205; Falla, Tr. (1/8 a.m.) at 149. White, as tax director, monitored pending tax legislation through Dow's Washington office, as did Paul Brink, White's successor.

b. Dow's pre-purchase analysis of legal issues

Among the legal issues explored was whether Dow had an insurable interest in all of the proposed insured employees. Jenkins raised the issue of insurable interest in an August 10, 1987 memo to White, concluding that a "corporation has an insurable interest in the lives of its officers, directors or managers (key men); however, the mere existence of the relationship of employer and employee is not sufficient to give the employer an insurable interest in an employee." Ex. J72. On October 5, 1987, Kirkland & Ellis, an outside law firm, advised Dow that it could structure a COLI program "so that the policies issued will not be void as a matter of public policy due to a lack of insurable interest." To do so, Kirkland & Ellis recommended that Dow (1) require all insureds to consent to insurance coverage, and (2) purchase an aggregate amount of insurance that was proportionate to the perceived potential liabilities to

employees under all benefit plans. Ex. J107; White, Tr. (1/10 a.m.) at 48. MetLife also brought the insurable interest issue to Dow's attention in its response to Dow's November 1987 RFP. There, MetLife attached a memo on insurable interest in large employee populations from Roy Albertalli, a member of MetLife's Law Department. Albertalli identified the same issues that had been raised in Jenkins's and Kirkland & Ellis's memoranda. Ex. J136 at A03870; Ex. J797; Lake, Tr. (1/14 a.m.) at 42; Ryan, Tr. at 1725:7-24.

Since the 1960s, Dow had used a "Hay Point" system to measure the importance of its employees to the corporation. The system evaluates and quantifies a job's content and value on three dimensions: know-how, problem-solving, and accountability. Falla, Tr. (1/8 p.m.)at 18; Pierce, Tr. at 4339-43. In December 1987, the COLI Task Force met and determined that the insured pool should be limited to approximately 4,000 employees at 238 Hay points and above, representing a compensation level of approximately $50,000 or more. Stip., ¶ 75. Promotion to a job assigned a Hay Point level of 238 required a performance review by a Dow Job Evaluation Committee. Falla and White testified that Dow requires this thorough review because it has long recognized 238 Hay Points as the equivalent of a middle management position; at 238 Hay Points, Dow employees became eligible for certain executive benefits, including stock options and performance incentive awards that were not available to employees at lower Hay Point levels. Falla, Tr. (1/8 p.m.) at 18-21; Ex. J149; Ex. J107; Ex. J132; White, Tr. (1/10 a.m.) at 46-49, 50-51, 52.

The reduction in the number of proposed insureds from the 20,000 reflected in the November 1987 RFP to 4,000 resulted from Dow's research of Michigan insurable interest law and the advice that it had received from MetLife and Kirkland & Ellis. Ex. J107; Ryan, Tr. 1725-26. Falla

and White explained that Dow selected 238 Hay Points as its cut-off for the eligible group of insureds because Dow considered these employees to be "key employees." Falla, Tr. (1/8 p.m.) at 18-19; Ex. J160; Ex. J179; White, Tr. (1/10 a.m.) at 51-52.

In 1987, the COLI Task Force received an opinion from Kirkland & Ellis that an issue may exist as to employee consent. Ex. J76; Ex. J107; White, Tr. (1/10 a.m.) at 48. As a result, in connection with the Great West COLI program, Dow asked each employee to sign a consent form that constituted an application for insurance and consented to Dow as owner and beneficiary under the policy. Dykhouse, Tr. at 2710-11; Ex. J253. Dow initially considered setting premiums at $16,667 per insured, but scaled back to $10,000 per insured because Dow had been advised by Kirkland & Ellis and MetLife that the most conservative route to follow with respect to insurable interest was to make sure the insurance was commensurate with benefit liabilities. Although Michigan law did not require them to adopt that approach, Dow followed this advice. Lake, Tr. (1/14 a.m.) at 25-26; Ex. J107; Dykhouse, Tr. at 2726-27.

Based on the legal analyses of Jenkins, VanAlsten, Kirkland & Ellis, and Roy Albertalli, its decision to limit the insured population to its highly compensated middle and upper managers and professionals, requiring the consent of insured employees, and selecting a $10,000 annual premium, Dow believed that it had an insurable interest in each of the 4,051 employees it insured in 1988. White, Tr. (1/10 a.m.) at 34, 71, 139. In 1987 through 1989 members of the Michigan Insurance Bureau did express concerns about insurable interest in the marketing of broad-based COLI plans for all of a company's employees. Bartlett, Tr. at 5015-16.

In addition, in 1987, Dow knew that it could not be the beneficiary of a group policy and therefore would not consider companies that only offered group policies. Ex. J1244; Ex. J146; Ex. P446; White, Tr. (1/10 a.m.) at 43-44; Lake, (1/14 a.m.) Tr. 40-41, 47. Dow's Great West COLI plan was filed, issued, administered, and accounted for as a program of individual insurance. Todd, Tr. at 708-09; Dykhouse, Tr. at 2854.

c. Dow's pre-purchase analysis of financial issues

The COLI Task Force also considered and resolved a number of financial questions, including (1) whether the internal rate of return on COLI proposals was acceptable to the corporation; (2) the potential disadvantages, both qualitative and quantitative; (3) which of the COLI products offered by the carriers had the best risk/reward relationship; (4) whether Dow should place the COLI policies with more than one carrier to avoid the risk of concentration; and (5) whether the contract language met the requirements to avoid the recognition of gross assets, liabilities, and expenses associated with the COLI policies for off-balance sheet financing. Ex. J77 at A011205-06; Falla, Tr. (1/8 a.m.) at 150-51; White, Tr. (1/10 a.m.) at 17. The off-balance sheet aspect of a life insurance investment that permits policy loans to be netted against the cash value asset on Dow's balance sheet apparently was significant to Dow in the context of its financial ratios and ratings. Falla, Tr. (1/8 a.m.) at 134-37, 150-51. Burdett testified that Dow was willing to pay up to 100 basis points over its normal borrowing cost to obtain the benefits of off-balance sheet financing. Burdett, Tr. at 1373-74. According to Lake, Dow's chief financial concerns were (1) selecting the plan that yielded optimal results on a NPV basis; and (2) obtaining an investment that matched Dow's goal of providing a pool of assets to defray its long-term liabilities

while minimizing its short-term cash outlay. Ex. J146; Lake, Tr. (1/14 a.m.) at 43-45.

As a portfolio investment, Dow required rates of return for COLI that were significantly lower than those for plant investments, and Dow's Board typically used an 8% NPV discount rate in its reviews. Falla, Tr. (1/8 p.m.) at 41-42, Tr. (1/9 a.m.) at 19-20. Falla argued that insurance was generally well suited to achieving Dow's long-term funding obligations by optimizing the balance between the NPV of Dow's investment and the build-up of funds for pay-out as death benefits in later years. Falla, White and Burdett all insisted that Dow intended to acquire the policies with a minimum cash outlay, borrow up to $50,000 per policy, withdraw to basis, and then to accumulate unencumbered cash value in the policies. Falla, Tr. (1/9 a.m.) at 17, 108-09, Tr. (1/9 p.m.) at 22-23, Tr. (1/8 a.m.) at 133-34; White, Tr. (1/10 p.m.) at 21; Burdett, Tr. at 1443; Ryan, Tr. at 1692; Jenkins, Tr. at 4623.

4. Aborted purchase of Connecticut Mutual & Great West policies

On October 2, 1987, the COLI Task Force attended a meeting with Dow's lobbyist from Washington, D.C. Ex. J95. The lobbyist indicated that two proposals were being considered by Congress: (1) limiting interest deductions to policy loans of $25,000 per employee and (2) disallowing all interest deductions. *Ibid.* Thereafter, Dow executed binders for insurance coverage with Connecticut Mutual and Great West on October 6, 1987. Stip., ¶ 72; Ex. J104. The Connecticut Mutual binder provided coverage for 20,000 employees and the Great West binder provided coverage for 10,000 employees. Stip., ¶ 72; Ex. J104. The binders required as a condition of temporary insurance coverage that Dow pay Connecticut Mutual $3,333,400 and Great West

$1,666,700. Ex. J109; Ex. J110. White testified that Dow executed these binders on the advice that tax law changes would likely be prospective, and the policies likely would be protected from pending legislation that would have eliminated several tax benefits associated with leveraged COLI. White, Tr. (1/10 a.m.) at 24-25. Each policy had an annual premium of $16,667 per employee. *Ibid.*

On October 21, 1987, Dow rescinded its binders with both Connecticut Mutual and Great West and requested the return of the binder premiums paid. Dow had determined that it was not yet ready to go forward with its COLI purchase for a variety of reasons, including concerns over insurable interest and Connecticut Mutual's ability to meet Dow's expectations. Stip., ¶ 73. In addition, the legislation that would have curtailed the use of leveraged COLI was not enacted. Ex. J120; Ex. J121; Falla Tr. (1/9 a.m.) at 67. White acknowledged that the binders were a mistake made in haste due to fear of the possible legislative amendments to the tax code. White, Tr. (1/10 a.m.) at 24-26. Immediately following the rescission of the binders, Dow began a painstaking review of COLI. Dow also decided to open up bidding to a wider group of insurance carriers and brokers in order to better evaluate the marketplace. Ex. J128; White, Tr. (1/10 a.m.) at 28, 31; Lake, Tr. (1/14 a.m.) at 42-43.

5. Formal RFP

On November 5, 1987, Dow sent out a formal Request for Proposal to seven insurance carriers. Ex. J127; Stip., ¶ 74. The RFP required bidders to prepare illustrations based on the following ten standardized assumptions:

1. Ages 27, 37, 47, and 57.
2. Up to 20,000 employees (assume 5,000

employees at each age).

3. 36.64% tax bracket.
4. 10.00% loan rate.
5. 7.00% unborrowed crediting rate.
6. $16,667 annual premium per employee.
7. Loans limited to $50,000 per employee.
8. (a) Aggressive COLI approach (i.e., minimum cash flow).
   (b) Traditional COLI approach (i.e., borrow first 3 years, pay next 4 years, no cash withdrawals).
9. Include after-tax cost of outside fees, if any.
10. (a) Mortality based on 60% of the 1960 CSG Table.
    (b) Mortality based on 100% of the 1960 CSG Table.

Ex. J127, Bates A004575. Proposals were required to provide illustrations with the specified information for each policy year, including after-tax outlay, gross and net death benefit, gross and net cash value, profit and loss impact, surrender value, and tax liability. Ex. J127, at A004575-76. The illustrations also were to show the present value of cash flows at 6%, 7%, 8%, 9%, 12%, and 15% and provide options in the event that inside build-up is taxed prospectively or policy loan interest is not deductible prospectively. Ex. J127, at A004576. Requiring illustrations based on alternative mortality assumptions allowed Dow to evaluate the impact of different scenarios for the timing of death benefits. Lake, Tr. (1/14 a.m.) at 12-13. Lake testified that he chose 60% of the 1960 CSG Table because he believed at the time it reasonably approximated Dow's mortality experience. *Id.* at 113. By standardizing the bid specifications, Dow sought an "apples-to-apples" comparison of the different insurance carriers. *Id.* at 12.

Section III of the RFP set forth conditions that Dow required bidders to meet in order to be considered. Ex. J127, Bates A004576-77. Subsection five required that "[o]nly Dow's mortality experience can be used in the calculation of the prospective cost of insurance or experience rated refund." Ex. J127, at A004577. Subsection seven required "[a]n unwind provision . . . in the event of legislation adversely impacting COLI during the first year the policy is in force." *Ibid.*

Section IV of the RFP set forth legal and administrative issues to be addressed by the bidders. Ex. J127, at A004577-79. In subsection A, Dow requested a guarantee from the insurance companies that "the policy does meet the four out of seven test[] and that it will not be deemed a single premium policy." Ex. J127, at A004577. However, Dow later backed away from this requirement.

Dow received responses to the RFP from seven or eight brokers, representing nine or ten insurance carriers. Lake, Tr. (1/14 a.m.), at 43. The carriers and brokers were as follows: Great West, Connecticut Mutual, and Connecticut General, all represented by Clark/Bardes; Amex Life and Hartford Life, represented by AYCO Corporation; Travelers, represented by AS&K Resources; Mutual Benefit, represented by MCG Group; Equitable of Colorado, represented by KARR-BARTH; Connecticut General and Metropolitan Life, represented by Marsh & McLennan; and Mutual Benefit, represented by Johnson & Higgins. Ex. J146.

On December 16, 1987, Gary Lake sent a memorandum to Glenn White which included charts summarizing the features of the each of the RFP responses. See Ex. J146. It also detailed a three-phase analysis process Lake suggested to eliminate carriers from consideration. In

Phase I, based on Lake's understanding that Dow "does not want to have significant cash payments," Lake suggested eliminating "[c]ompanies not quoting on an 'aggressive basis'" and "[c]ompanies requiring large cash outlays even on an 'aggressive' basis." Ex. J146, Bates A008880. Lake also suggested eliminating in Phase I insurance carriers unwilling to file on an individual policy basis and those carriers not large enough to handle the size of Dow's purchase. *Ibid.*

In Phase II, Dow would compare the net present values of the proposal. Ex. J146, at A008881. Phase II also involved decisions by Dow on insurable interest concerns, "whether Dow is comfortable with a loan rate higher than Moody's Corporate Average," what employee groups would be included, and the level of death benefits or premiums per employee. This phase included evaluation of the administrative expertise of the brokers. Ex. J146, at A008881. *Ibid.*

Phase III would "evaluate the remaining carriers from a number of different points of view, the most important of which is the net present value gain produced by the cash flows." Ex. J146, Bates A008882. Phase III was a final evaluation of the remaining bidders in which Dow, with Lake's help, would consider a wide range of "qualitative" factors, including financial performance of the proposals and administrative capabilities of the brokers, legal issues, insurance carriers, and the insurance policy. *Ibid.* Phase III also involved requesting that the bidders consider reductions in charges and commissions. Lake, Tr. (1/14 a.m.) at 48-49, 13-14, 36, 47.

6. Pre-purchase Illustrations (Pre-tax and After-tax Policy Performance)

Lake recommended the purchase of the Great West policy because its quantitative and qualitative results produced a conservative approach that he was comfortable recommending to Dow. Lake, Tr. (1/14 a.m.) at 4-5. Lake described his role as showing Dow the bad news that was not included in the broker's and insurance company's illustrations. *Id.* at 10-11. Brokers were providing proposals showing policy loans in excess of $50,000. However, to be considered in the final evaluation, they needed to submit the proposals which capped loans at $50,000. *Id.* at 38-40.

Great West was using a 9% credited rate on unborrowed funds in its proposals. This was a positive feature and would increase inside build-up values on unborrowed funds. (Lake, 0114A, 59). According to Lake, Mutual Benefit was rejected because of its "aggressive" features, which he identified as enhanced policy loan rates and arbitrary dividends. *Id.* at 62-63. The cash flow numbered "2" from the Great West illustration served as the decision illustration. *Id.* at 63-64. Lake testified that the dividends in the Great West policy had a fairly minimal impact. To look at the worse case scenario, Lake looked at the net policy value gains. Had Congress eliminated any of the tax benefits (inside build-up, death benefits, or deductibility of interest), the COLI policy would not perform as well. Therefore, Lake tried to eliminate some of these benefits in terms of the worse policy performance possible. *Id.* at 95-98.

The mortality rates used for pricing cost of insurance were different in Great West's, Mutual Benefit's and Connecticut Mutual's illustrations: they were all using different mortality rates to price the cost of insurance. *Id.* at

114-115. Low mortality charges would show better net present value numbers. *Id.* at 116. In August 1987, Gary Lake requested policy illustrations from Mutual Benefit using an aggressive approach. Lake, Tr. (1/14 p.m.) at 240-41. Lake stated that the main concern in looking at illustrations was the net present value of after-tax cash flow. He also stated that he would sometimes look at the cumulative amount of after-tax cash flows. *Id.* at 252.

Defense Exhibit 697 is an illustration from Clark/Bardes of the Great West policy cash flows. Lake, Tr. (1/15 a.m.) at 103. Lake noted that taking withdrawals above basis would help eliminate the (funding) of negative cash flows. *Id.* at 104. He stated that the purpose of running many illustrations was not to try to figure out a way around having negative after-tax cash flows and the problem of paying taxes. Rather, he stated that illustrations were continuing to be produced because they were not meeting what Dow had asked for. He further stated that Dow wanted to limit loans to $50,000. *Id.* at 105-08.

Lake did receive an illustration with no cap on loans and which showed no negative cash flow. Ex. J294, at GDL65; Lake, Tr. (1/15 a.m.), at 129-30. Lake did not make any illustrations showing the effect on Great West. *Id.* at 138. If Dow borrowed the maximum possible or to the extent of cash value, that, by definition, would produce zero equity. Lake stated that for some of the years the purpose was to have low net equity. *Id.* at 142. Even if an illustration showed significant negative cash flows to Great West, Lake would not conclude that the illustration was flawed; he observed that the illustrations were not guaranteed. *Id.* at 143. Lake was not aware that the Clark/Bardes illustrations were compiled without the involvement of Great West. Lake, Tr. (1/15 p.m.) at 425.

Mel Todd from Great West believed the mortality charges and all the expenses and loans within the Great West policy were properly illustrated when Dow received the illustration when they purchased the program. Todd, Tr. at 921. Ronald Laeyendecker, also from Great West, stated that by signing the illustrations, the mortality assumptions were deemed "reasonable." He did not state that they were necessarily "accurate." Laeyendecker, Tr. at 1170-72. Beginning in 1991, Clark/Bardes used Dow's mortality table when running its illustrations. *Id.* at 1173. Dow evaluated the after-tax cash flows and, according to White, the pre-tax cash flows and found that both the after- tax and pre-tax figures produced a positive cash flow. White, Tr. (1/10 a.m.) at 77. Dow believed that by going with the program offered by Clark/Bardes on behalf of Great West, it would receive a $60 million net present value. *Id.* at 58-60. The recommended operation included withdrawing cash in the policy in excess of basis in the middle years. Ex. J189, at A012466-67; White, Tr. (1/10 p.m.) at 45.

The illustrations from Clark/Bardes for Connecticut General and Great West showed withdrawals in excess of basis about year twenty through year twenty-six of the policy. Ex. J172, at A009160; White, Tr. (1/10 p.m.) at 46-47. The memo from Gary Lake states that "in order to prevent any negative cash flow, cash withdrawals are taken out above the premiums paid, which would require a tax to be paid, but this does eliminate the negative cash flow." *Id.* at 45. Although one illustration showed withdrawals being made in years nine through thirty-one, White said that only a person who is "very stupid" would make those withdrawals. *Id.* at 46-47.

The illustration prepared by Clark/Bardes on November 11, 1988 indicates that Dow would take loans in years one through three, eight through nine, and eighteen

through sixty-seven. White states it was Dow's intent to take loans in years one through three, eight and nine to reach the $50,000-cap, despite the fact that the illustration clearly indicates that loans would not be capped at $50,000. *Id.* at 51-52. White indicated that the illustrations he reviewed were based on interest and premium borrowings up to $50,000, borrowing for the first three years and then for the eighth and ninth year. The illustrations were also based on tax exempt treatment of the inside build-up to create a positive cash flow. *Id.* at 63.

Exhibit J189 is an illustration from Clark/Bardes which capped loans at $50,000. When the cash flow is considered against the tax savings from interest deductions, there is positive cash flow in both the early part and across the entire life of the plan, even when the benefit of the interest deduction is not considered:

Great West Illustration Dated 2-3-88
(in 1,000's)

Interval	Tax Savings	Cash Flow	Cash Flow Absent Interest Deduction
10 yrs	$ 44,476	$ 48,816	$4,340
20 yrs	110,288	125,472	15,184
30 yrs	164,210	152,008	(12,202)
40 yrs	198,558	194,532	(4,026)
50 yrs	211,954	257,732	45,778

See Ex. J189.

7. Decision to Purchase Great West Policy

On March 18, 1988, the COLI Task Force recommended to Falla that Dow purchase the Great West COLI policies and hire Clark/Bardes to perform administrative support. Stip., ¶ 76. On April 11, 1988, Burdett provided a "Resolution to Authorize an Expanded

Corporate Owned Life Insurance (COLI) Program" to be placed on the April 14, 1988 agenda of the Board of Directors Meeting. The resolution explained that "[t]hrough a tax arbitrage between tax-deductible interest on policy loans and nontaxable internal build-up in the policy, COLI permits the Company to build a pool of assets available for any future corporate or employee benefit requirement." Ex. J204, at A009027. On April 14, 1988, the Board of Directors approved the resolution authorizing the purchase of the Great West COLI plan. Stip., ¶ 77.

8. "Backdating" and Effective Date

Great West received a preliminary census for Dow's Great West program in April 1988, shortly after Dow's Board of Directors approved the resolution authorizing the transaction, indicating 4,359 eligible insureds. Michigan law permits an insurer to issue policies taking effect less than six months before the application for insurance provided it does not result in a more favorable premium. Mich. Comp. Laws § 500.4046. Dow and Great West entered into an Application for Insurance on May 9, 1988. The Common Due Date for individual policies, as defined by the Application, was May 9, 1988.

The specimen policies were delivered to Dow on June 20, 1988. Because of a clerical error, reprinted specimen policies were delivered to Dow in November 1988. The consent forms were reconciled with the eligible insureds on October 12, 1988. The final census was 4,051 insureds.

9. Features of the COLI Contract Purchased

Dow's Great West COLI policy form includes a base policy, Form X105, and the following riders and amendments: Form X2, Form X35, Form X37, Form X92,

Form X33CB, and Form X31CB. Stip., ¶ 43.

a. Base Policy

The base policy and the X2 rider are the same as in the 1985 Great West COLI policies. Pierce, Tr. at 4331. Dow is both the owner of the 4,051 policies and the beneficiary entitled to receive death proceeds. Stip., ¶ 44. Policy Form X105, the base policy, is a traditional participating, whole-life policy called Life at 95 (L-95). Stip., ¶ 45. Level annual premiums were payable starting at issue and continuing to attained age 95. The base policy's death benefit, premiums, and cash values were fixed at issue. Mel Todd, who designed the L-95, stated that the base policy was designed to minimize cash value and maximize death benefits. Todd, Tr. at 599. As a participating policy, dividends were determined by Great West and may be applied to pay premiums or to purchase paid-up additions of cash value and death benefits. Stip., ¶ 46. No partial withdrawals of cash value are permitted under the L-95 policy.

b. The X-Rider

Dow purchased Form X2, the Additional Paid-Up Life Insurance Rider (X-Rider), on its policies. Stip., ¶ 47. The X-Rider allowed a policyowner to purchase additional (paid-up) insurance but offered a different mix of cash value and death benefits without additional expense loads. Stip., ¶ 47; Lake, Tr. (1 / 14 a.m.) at 68; Todd, Tr. at 612. The purchase of paid-up insurance increased both the cash value and the death benefit of the policy by an age-based factor determined under I.R.C. § 7702. Stip., ¶ 47-48. The X-Rider was available for purchase in multiples ranging from 2 through 10 times the base policy. Dow chose the 10-times multiple option. Stip., ¶ 49. Thus, because the X-Rider's

death benefit is based on a multiple of cash value, the death benefit increased as the cash value increased. Stip., ¶ 49. Unlike the L-95, the X-Rider was designed to provide the maximum amount of cash value and the minimum amount of death benefits permissible under I.R.C. § 7702. Todd, Tr. at 612. There were no commissions or expense charges built into the premium of the X-Rider; instead, the entire amount of the X-Rider premium was credited to cash values. *Id.* at 616-17. The expenses and mortality charges of the rider were recovered through the interest rate spread. Lake, Tr. (1/14 a.m.) at 69; Todd, Tr. at 616-18, 781.

c. The Term Rider

The Term Life Insurance Option, Form X35 (Term Rider), provided an additional death benefit for ten years, or, if earlier, to the paid-up insurance date of the X-Rider, in the amount of a term insurance factor of one, two, or three times the death benefit of the X-Rider. The term insurance factor depended solely on the issue age of the insured: for ages under 50, the term factor was 3; for ages between and including 51 and 55, the term factor was 2; and for ages between and including 56 and 60, the term factor was 1. Stip., ¶ 55; Ex. J191; Todd, Tr. at 645-48. No additional premium amount was required by the term rider. Rather, the additional COI was covered by increasing the spread between the policy loan interest rate and the crediting rate on the X-Rider's cash value by the same multiple (2, 3, or 4) as the death benefit. Stip., ¶ 56. The term rider had the effect of reducing the amount of Dow's potential borrowings by expending inside build-up on term insurance. Todd, Tr. at 644-47.

The purpose of the Term Rider was to reduce the impact of proposed Financial Accounting Standard (FAS) 96, initially to become effective on January 1, 1989, by

converting cash value into immediate death benefits. *Id.* at 644-45; Ex. J191; Lake, Tr. (1/14 a.m.) at 72; McGill, Tr. at 5473-74. FAS 96 would have required a corporate owner of life insurance to record a deferred tax liability on its financial statements equal to the tax on the inside build-up as if the policy were surrendered at the end of the year. Ex. J191; Lake, Tr. (1/14 a.m.) at 73; Todd, Tr. at 644. When FAS 109, Accounting for Income Taxes, was implemented, it superseded proposed FAS 96; therefore, FAS 96 was never implemented. Ex. J191; Lake Tr. (1/14 a.m.), at 73. In 1997, the Term Rider was extended for ten years. Stip., ¶ 55.

d. Paid-up Insurance Amendment

The Paid-Up Life Insurance Amendment, Form X37, modified the paid-up insurance benefit of the X-Rider so that coverage would continue with the cash value and death benefit computed in the same manner as before the policy went paid-up. Stip., ¶ 50. This rider applies only to the X-Rider. Lake, Tr. (1/14 a.m.) at 70-72. The Paid-Up Life Insurance Amendment allowed Great West to continue to adjust the loan interest spread once the rider became paid-up instead of, as required by the rider's provisions, paying a dividend. Laeyendecker, Tr. at 1328; Sayre, Tr. at 5472-73; Ex. J191, at A005981.

e. Modified Cash Surrender Benefit Rider

Because the L-95 policy had no cash value in the first year and low cash values in the early policy years, the Modified Cash Surrender Benefit Rider, Form X33CB, provided enhanced early year cash surrender values for the L-95 base policy by deferring certain expenses (commissions and certain marketing overrides) so that cash value could accumulate in year one of the policy. Stip., ¶ 51; Todd, Tr. at 868. Under Form X33CB, the L-95 base policy had a first

year cash value equal to 90% of the premium. Todd, Tr. at 597. A non-commissionable single premium of $15.38 per policy was assessed for the rider. The rider had the effect of deferring commissions on the base policies for three years. *Id.* at 696-98; Lake, Tr. (1/14 a.m.), at 71; Ex. J191. Ultimately, Great West stripped the commissions out of the product. Sayre, Tr. at 5476-77. The rider also improved the impact of the policies on Dow's profit and loss statement, because without the rider, Dow would have had to record premium expenses on the L-95 base policy without an offsetting entry for the increased cash value. *See* Stip., ¶ 50. Neither the Paid-Up Life Insurance Amendment (Form X37) or the Modified Cash Surrender Benefit Rider (Form X33CB) increased Dow's ability to the leverage. Lake, Tr. (1/14 a.m.) at 72.

f. Partial Withdrawal Provision Amendment

The Partial Withdrawal Provision Amendment, Form X31CB, allowed one partial withdrawal per year from the X-Rider beginning in the second policy year and before the X-Rider became paid up. Stip., ¶ 52. The amount of the partial withdrawal was limited by the amount of unencumbered cash value at year-end. Laeyendecker, Tr. at 1220-21; Ex. J1147, at CBTX020204. The purpose of the Partial Withdrawal Rider was to allow the policyholder to withdraw cash value from the X-Rider while maintaining the same death benefit for a certain period. Todd, Tr. at 597, 691-93. Thus, the amendment provides that for each withdrawal in years two through seven, the death benefit just prior to the withdrawal was maintained for the term of the amendment. Stip., ¶ 53. After the seventh year, the death benefit was reduced by the amount of the prior withdrawals. In the absence of the amendment, the reduction in cash value from the partial withdrawal would have lowered the total available death benefit, which could have caused adverse tax

consequences under I.R.C. § 7702, the section of the code which, essentially, distinguishes cash value insurance contracts, which enjoy the favorable tax treatment discussed herein, from annuity contracts, which are treated less advantageously under the tax code. Todd, Tr. at 597, 691-93. Form X31CB was extended through the fifteenth policy year to maintain compliance with I.R.C. § 7702(f)(7). Stip., ¶ 53. The charge for a partial withdrawal was 2.5% plus the state premium tax rate times the withdrawn amount. Stip., ¶ 54. The 2.5% charge was intended to cover the cost of insuring the additional net amount of risk created by maintaining the higher death benefit following the withdrawal. Laeyendecker, Tr. at 1103-04.

This combination of riders and amendments was unique to Dow; Great West did not sell this particular product to any other customer. However, Dow's Great West COLI policies were part of a pool of participating policies in which all of the policy owners shared in the mortality experience of the overall pool. Todd, Tr. at 599; Laeyendecker, Tr. at 1042-43.

10. Payment of the Premiums

Each of the 4,051 Great West COLI policies required a premium of $10,015 in the first policy year: $932 for the base policy, $9,068 for the X-Rider, and $15 for the Modified Cash Surrender Benefit Rider. Stip., ¶ 84. In policy years two through nine, each Great West policy required a $10,000 premium: $932 for the base policy and $9,068 for the X-Rider. In policy years 10 and later, premiums were only required to be paid on the base policy. Stip., ¶ 85. Premiums for the X-Rider were projected to stop after the ninth policy year because Dow would "voluntarily" stop paying premiums, causing the rider to enter non-

forfeiture status and allowing the rider to be treated as "paid up." Sayre, Tr. at 5572-77.

In the first twelve years, the total amount of gross premiums under Dow's Great West program was $373,400,000. Dow took policy loans totaling $50,000 per policy to pay premiums for the first, second, third, eighth, and ninth policy years. Dow took partial withdrawals to pay premiums in the fourth through seventh policy years. As a result of the payment offsets in the form of policy loans, dividends, and partial withdrawals, Dow only paid $56,893,000, or 15.2%, of the gross premium amount in cash. *Ibid;* Ex. D813.

a. Policy Loans

The Great West COLI policies allowed Dow to take policy loans using the cash values of the L-95 base policies and the X-Rider as collateral. Stip., ¶ 57. The maximum loan value was equal to the end-of-year cash value (including premiums deemed paid in simultaneous netting transactions on the policy anniversary) less the loan interest payable to the end of the policy year. Ex. J1147, at A020188; Laeyendecker, Tr. at 1221; Todd, Tr. at 625-27, 637-38, 892-99. Policy loans and repayment of loans were first applicable to the X-Rider, unless otherwise specified by the policyholder. Stip., ¶ 58. None of Dow's loans from Great West reduced policy cash values or the amount of interest credited to policy cash value. *See* Ex. J1147, at CBTX020188. The credited rate on the Great West policies was the same for both borrowed and unborrowed funds. Great West's computer system was not capable of assigning different crediting rates to the borrowed cash value on one hand, and cash value that remained in the policy on the other.

Each of Dow's loans from Great West required the annual payment of interest in arrears on the policy anniversary. Stip., ¶ 308. Failure to pay interest resulted in the interest being "added to the loan and [] bear[ing] interest at the loan interest rate." Ex. J235, at 10. Each loan from Great West that was outstanding upon termination of the policy was repaid as an offset against death benefits or against the amount payable upon the full surrender of the policy. Ex. J235, at 11; Ex. J1147, at CBTX020189; McGill, Tr. at 5153-54, 5324. Dow had the right to pay off each of its policy loans, or any part thereof, at any time. Ex. J235, at 11.

The maximum variable policy loan interest rate under Dow's Great West COLI policies was the greater of (1) the Moody's Corporate Average for the calendar year ending two months before the beginning of the policy year or (2) the rate used to compute the cash surrender values under the policy during the applicable period plus 1% per annum. The loan interest rate was determined at the beginning of each policy year and was guaranteed for all loans outstanding in that year. Stip., ¶ 59.

b. Partial Withdrawals

As stated above, the Partial Withdrawal Provision Amendment allowed one partial withdrawal per year from the X-Rider, limited by the amount of unencumbered cash value at year- end, beginning in the second policy year and before the X-Rider became paid-up. It was both the opinion of Mel Todd, former Great West Vice President and Actuary, and Great West's formal position, that the partial withdrawal should not be performed in a netting transaction. An internal Great West memorandum stated that "[p]remiums must be credited to the X-Rider cash value first in order to have enough cash value to do a partial withdrawal. The money

will then come out of the policy as a partial withdrawal. Premium payment is also important to clients who wish to leave a paper trail of premium payments." Ex. J191, at A005983; Todd, Tr. at 842, 849-50; Burdett, Tr. at 1623, 1625-26; Ex. J424, at A006356.

Dow took partial withdrawals to cover the premiums for policy years four through seven, inclusive. This procedure was different from Dow's 1985 Great West COLI polices where Dow paid the premiums in cash in years four through seven. The partial withdrawal transactions were structured to occur on separate days in a three-step transaction: (1) Dow sent a check for the full premium by overnight mail to Great West on May 8, (2) Great West received and deposited the check on May 9, and (3) after the premium check cleared on May 10, Great West wired the partial withdrawal to Dow. Todd, Tr. at 849; Burdett, Tr. at 1622-25; McGill, Tr. at 5155-56; Ex. J448.

c. Loading Dividends

Great West determined that the use of a loading dividend structure was an inappropriate mechanism to pay premiums in policy years four through seven because the dividend formulas did not follow industry norms and practices or actuarial standards. Dow's Great West COLI policies did not provide for loading dividends.

11. Calculation of Mortality and COI

The COI for the X-Rider was paid through the spread—the difference between the interest rate charged on borrowed funds and the amount credited on policy cash value. The annual COI charges were calculated based on actuarial data intended to reflect Dow's actual mortality experience, using Great West's proprietary 1982 Asset Share

Pricing Mortality Table, adjusted to reflect Dow's actual experience as measured by analyzing the medical claims of a portion of the proposed insured group. Based on this information, Great West initially set the spread for the X-Rider at 100 basis points, and provided that it could be adjusted up or down to reflect Dow's actual experience going forward. In actuality, Dow's mortality experience was more favorable (i.e., Dow experienced fewer employee deaths) than anticipated, resulting in a reduction of the spread. But this was done on a prospective basis. There was no retrospective adjustment – or refund of excess COI – paid by Great West to Dow at year end. Dividends were paid, but only in accordance with the experience of the entire pool of policyholders of par policies in conformity with industry practice.

12. Actual Performance of the Policies

Dow and Clark/Bardes entered into an Administrative Services Agreement for Dow's Great West COLI program on May 2, 1988. Stip., ¶ 93. The Administrative Services Agreement outlined the services previously rendered and to be rendered by Clark/Bardes in relation to Dow's Great West COLI policies. Stip., ¶ 93.

Clark/Bardes provided Dow with various initial, ongoing, annual, and consulting services. The initial services included (1) electronically storing Dow's demographic data, (2) recommending alternative funding mechanisms for the purchase of Dow's Great West COLI policies, (3) preparing cash flow analyses with varying tax brackets for the final funding design, (4) preparing projected profit and loss impact analyses in accordance with FAS 96, (5) consulting with Dow on potential tax law changes, (6) illustrating modifications to the plan design and objectives, and (7) assisting in the selection of the appropriate life

insurance carrier. Ex. J229, at A008486-87. The ongoing administrative services include (1) processing death claims, (2) inventorying policies on terminated participants, (3) furnishing any information requested by Dow regarding life insurance policies, and (4) interacting with outside counsel and auditors, if necessary. Ex. J229, at A008487. On an annual basis, Clark/Bardes would (1) review I.R.C. § 264 prior to Dow's billing date, (2) prepare supplemental billing statements illustrating which premiums to pay or borrow, (3) prepare cash value reports, and (4) prepare revised cash flow and profit and loss projections reflecting changes in the status of the plan. Ex. J229, at A008488. Clark/Bardes agreed to perform the following consulting services: (1) review new product enhancements on existing policy contracts, (2) review changes in tax laws or proposed tax laws that could impact Dow's Great West COLI, and (3) review with Dow's accountants changes to Dow's COLI plan that would be favorable. *Ibid.*

Under the terms of the Administrative Services Agreement, Dow agreed to pay Clark/Bardes an initial administrative fee of $800,000, payable six months after the policy date. Dow also agreed to pay Clark/Bardes an additional administrative fee of $2 million if the policies were still in force at the end of the thirtieth month and an ongoing administrative fee of $40 per policy on the actual number of policies renewed each year. Stip., ¶ 94. Clark/Bardes received compensation from Great West as commissions for serving as broker on Dow's Great West COLI purchase. Stip., ¶ 95.

The table below reflects Dow's operation of its Great West COLI policies:

Great West Cash Payment—Aggregate (In Thousands)						
Year	Premium	Policy Loan	Policy Loan Interest	Dividend	With-drawal	Dow Cash Payment
5/9/88	$40,582	$38,866	0	0	0	$1,717
5/9/89	$40,470	$38,021	$3,827	0	0	$6,276
5/9/90	$40,440	$40,440	$7,594	0	$1,751	$5,842
5/9/91	$40,360	0	$11,278	0	$45,149	$6,489
5/9/92	$40,300	0	$10,934	0	$44,878	$6,356
5/9/93	$40,160	0	$10,185	0	$42,912	$7,434
5/9/94	$40,090	0	$9,308	0	$45,185	$4,213
5/9/95	$40,050	$44,240	$8,576	0	0	$4,387
5/9/96	$39,880	$39,751	$13,570	0	$7,290	$6,409
5/9/97	$3,702	0	$14,442	$3,685	$12,343	$2,116
5/9/98	$3,689	0	$15,024	$3,169	$12,616	$2,925
5/9/99	$3,677	0	$13,709	$1,122	$13,667	$2,597
5/9/00	$3,661	0	$13,539	$1,228	$13,054	$2,919
TOTAL	$377,062	$201,317	$131,986	$9,203	$238,844	$59,679

See Stip., ¶ 92.

In 1996, the policies went into "paid-up" status. At that time, the death benefit became level. J1147, at CBTX010198.

The financial performance of the Great West policy was very disappointing to Dow, primarily because of its favorable mortality experience. For instance, between 1989 and 1997, Dow expected 266 deaths based on the mortality table used in the RFP. However, it experienced only 79 deaths. Great West had used pricing data projecting 216 deaths over the same period. The result was that Dow received $35 million less in death benefits than Great West projected. Dow's projected net annual after-tax cash flow was a positive $26 million. The actual after-tax cash flow to Dow was a negative $4 million. Lacyendecker, Tr. at 1067-69. Dow's reaction was motivated by its strong belief that it was overcharged for COI. In fact, Falla was "outraged" because the mortality of Dow was lower than the projections. Dow expected Great West to "come up to the plate" to make up a portion of that difference. Falla, Tr. (1/9 a.m.) at 111-

116. Representatives met on January 31, 1991, and according to a memo from the meeting, J404, the purpose was to analyze Dow's cumulative mortality experience to date compared to what Great West and Clark/Bardes originally expected. According to the Great West representatives, "Our objective will be to adjust the policies to more accurately reflect your current and ongoing mortality and, thus, create a revised financial projection." *Id.* at 115.

Great West did, in fact, make adjustments. For instance, the spread for COLI policies, other than Dow's, was being increased to 1.25% due to the DAC tax, but Dow's spread remained at 100 basis points for 1991. Todd, Tr. at 965, 1012. The March 22, 1991 memo from Clark/Bardes (J416) indicates that "Great West is willing to reimburse Dow most of this unexpected gain" from favorable claims experience. Falla testified that this adjustment was on a "prospective basis." Great West would "reimburse" through "a major reduction in the crediting rate spreads between the interest rate Dow has on the borrowed funds and the rate credited by Great West to these borrowed funds." Falla, Tr. (1/9 a.m.) at 116-17. Thereafter, "Dow's actual mortality experience may be used in the calculation of the X-Rider interest spread which is used to recover cost of insurance." Ex. D94, at A012184; Falla, Tr. (1/9 a.m.), at 120. In the unlikely event that Dow's actual death claims would continue at a level much lower than expected, Great West would (1) lower interest rate spreads, including using a negative interest spread, or (2) pay higher dividends on the base policy. Ex. J432; Falla, Tr. (1/9 a.m.) at 123-24.

Great West reduced the spread on the X-Rider below 100 basis points, even to as low as 25 basis points one year. In 1997, it released $4.5 million to divisible surplus and paid it to Dow as a dividend. However, this decision was driven by a belief that a reserve that had been set aside in the

participating account had become "redundant," and was no longer needed to cover the risk in connection with Dow's policies.

The government points to Dow's strongly-worded demands for a "refund" as evidence that Dow expected – and intended – some true-up mechanism in mortality pricing. However, based on the testimony and exhibits, the Court is convinced that Dow was protesting what it believed was an overcharge on the mortality risk from the beginning of the arrangement. Dow was protesting pricing, not performance. Dow was not seeking to cancel its mortality bet and back out of the game. Rather, it was complaining that the game was rigged from the outset. That, essentially, is the difference between the risk-eliminating "true-up" mechanism used in the MBL policies in *AEP* and *CM Holdings,* and the prospective odds-improving mechanism in the Great West policies. In the former, past risk was eliminated. In the latter, future risk – still extant – was managed.

The government argues that when the X-Rider spread was reduced below the level necessary to cover prospective COI for the coming year, it amounted to a refund of the prior year's mortality charges. However, this mechanism still was subject to the risks attendant to projecting future mortality experience, albeit reduced. There was no retrospective "truing-up" mechanism built into the Great West policies.

G. Dow's Purchase of MetLife Policies

1. Business Purpose and Change in Michigan Insurable Interest Law

On December 1, 1990, the Michigan Legislature passed Public Act 349, amending Section 2210 of the Michigan Insurance Code, Mich. Comp. Laws § 500.2210.

The new statute recognized an employer's insurable interest in the lives of its officers, directors, management, non-management, and retired employees, subject to the employee's consent.[2] Ex. J564. For non-management and retired employees, the insurable interest is limited to a level commensurate with the employer's projected unfunded benefit liabilities.

Because of the law change, Dow began in 1991 exploring an expanded COLI program. Stip., ¶ 96. Another COLI Task Force was appointed by Falla in June; the members of the 1991 COLI Task Force were Burdett, who was the chair; Paul Brink, head of Dow's corporate tax department; Anita Jenkins, attorney in the tax department; Loren Pierce, corporate compensation and benefits; Kevin Rowe, accounting; VanAlsten, legal; and Heino Zell, head of human resources. Stip., ¶ 98. Gary Lake was again hired as the Task Force's actuarial consultant. Stip., ¶ 98. Because

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[2] Section 500.2210 of Michigan's Insurance Code provides that

> [n]otwithstanding any other section of this act, an employer or a trust has an insurable interest in, and may, with the written consent of the insured, insure on an individual or group basis for its benefit the lives of the employer's directors, officers, managers, nonmanagement employees, and retired employees. An employer or a trust may insure the lives of the employer's nonmanagement employees and its retired employees only if those persons give written consent to be insured and the coverage is limited to an amount reasonably commensurate with the employer's projected unfunded liabilities to nonmanagement and retired employees for employee benefit plans, calculated according to accepted actuarial principles. An employer shall not retaliate in any manner against an employee or a retired employee for refusing consent to be insured.

Mich. Comp. Laws § 500.2210 (1991).

four of the members (Burdett, Jenkins, Pierce, and VanAlsten) of the 1991 COLI Task Force participated in 1988 and were already familiar with COLI, the process concluded with signed agreements in about six months. Because the tax law had not changed and Dow's 1988 analysis of the tax issues was viewed as correct, little work in the legal area was necessary for the COLI Task Force. Brink, Tr. at 2395-97.

Dow's unfunded retiree medical liability in 1991 was still estimated at over $1 billion NPV. However, as of 1990, Dow was in Alternative Minimum Taxpayer (AMT) status. As an AMT taxpayer, seventy-five percent of the otherwise tax-exempt inside build-up of interest, withdrawals, and death benefits were includable in alternative minimum taxable income in those years under the Alternative Current Earnings adjustments in I.R.C. § 56(g). The value of the interest deduction was also reduced from the illustrated 34% corporate tax rate to the AMT rate of 20%. Dow emerged from AMT status in 1995 and recovered $22 million in adjustments.

The 1991 COLI Task Force received presentations on August 25, 1991 by Great West, MetLife, Hartford Life Insurance Company, and CIGNA. Based on performance of the Great West policies, Dow determined it wanted its actual mortality reflected in these new policies while still maintaining some type of transfer of risk. Following the presentations, the Task Force compared the economics of the proposals submitted.

2. Pre-purchase Illustrations

Following the August 1991 interviews, Clark/Bardes and Lake obtained illustration from several carriers enabling Dow to compare the "policy economics" of the various

proposals. Burdett, Tr. at 1425-26. On September 23, 1991, Lake received from Clark/Bardes a "Carrier Analysis" including two sets of projections for the MetLife plan, titled Scenario 1 and Scenario 2. *Id.* at 1427- 29; Ex. J523. Scenario 1 was based on a payment strategy of capping loans at $50,000, thereby requiring Dow to contribute cash to the plan after the period of withdrawals to basis. Scenario 2 was based on an uncapped loan strategy, requiring Dow to contribute only minimal cash to the plan after the period of withdrawals to basis. The analysis showed the undiscounted cash flows, net present values at 8% and 12%, and internal rates of return for both scenarios. Ex. J523. Burdett stated that the economics of the Scenario 1 was more appropriate because it had larger undiscounted cash flows projected to occur principally in the later plan years. Burdett, Tr. at 1428-29.

From August 6, 1991 to October 9, 1991, Winkelvoss Consulting, Inc., an outside service with whom MetLife had contracted, ran several cash flow and earnings illustrations of the MetLife program for Dow using a variety of assumptions, including loans capped at $50,000 and maximum loans beyond the $50,000 cap. Yau, Tr. at 2178; *E.g.*, Exs. J528, J556. The final two pre-purchase illustrations were the Case 23 and Case 24 illustrations.

Case 23 capped loans at $50,000; it represents an illustration for one person, age 40. Ex. J557. It reflected premium payments of approximately $10,000 each year for the first eight years with borrowing in the first three years (totaling about $30,000), no borrowing for the fourth through seventh years inclusive (but partial withdrawal of approximately $11,900 each year), and borrowing in years eight through eleven inclusive until the $50,000 cap is reached. Ex. J557. Partial withdrawals continued in years eleven through eighteen, inclusive. Ex. J557. The

illustration calculated net present value at discount rates of 7%, 8%, and 12%. Ex. J557.

Case 24 did not cap loans at $50,000. Like Case 23, it represented an illustration for one person, age 40. Ex. J557. It reflects premium payments of approximately $10,000 per year for the first eight years with borrowing in the first three years (totaling about $30,000), no borrowing the fourth through seventh years inclusive (but partial withdrawals years three though seven inclusive totaling about $48,000), and borrowing in years eight through fifty-nine inclusive, totaling about $280,000. Ex. J557. The illustration provided for the net present value calculations at 7%, 8%, and 12% discount rates. Ex. J557.

Case 23 provided for an increased unborrowed crediting rate of 8.75% after policy year seventeen. In contrast, Case 24 provided for a crediting rate of 5.5% in all years. Ex. J1274, at A013568. These cases also reflected a 2.2% retention rate negotiated between Dow and MetLife. *Ibid.* Dow states that because it was its intention to cap loans at $50,000, the Board of Director's decision was based on Case 23, not Case 24, because the net present value was higher and the payouts on a year-by-year basis would come in the later years. Lake, Tr. (1/14 p.m.), at 173-78; Ryan, Tr. at 1692; Burdett, Tr. at 1443.

Exhibit J550, a letter from John Ryan of MetLife to Gary Lake dated October 8, 1991, contains the Case 23 illustration which shows the policy performance over the full 60 years. When the cash flow is considered against the tax savings from interest deductions, there would be negative cash flow without the tax deductions until later in the plan. The overall plan performance, however, would be positive even without the loan interest tax deductions.

MetLife "Case 23" Illustration

Interval	Tax Savings	Cash Flow	Cash Flow Absent Interest Deduction
10 yrs	$10,032	$ 6,559	$ (3,473)
20 yrs	25,358	11,809	(13,549)
30 yrs	39,112	1,538	(37,574)
40 yrs	49,308	47,781	(1,527)
50 yrs	54,155	172,593	118,438
60 yrs	55,020	268,282	213,262

See J550.

3. Decision to Purchase MetLife Policy

The COLI Task Force met in September 24, 1991 and selected MetLife as the carrier and Ayco as the administrator for the 1991 COLI policies. In Burdett's letter to MetLife on October 1, 1991, he stated that "it is important to Dow that this COLI program be up and running by January 1, 1992." Ex. J536. The next day, Dow's Treasury Department submitted a board resolution seeking authorization to purchase the MetLife COLI program. The memorandum accompanying the resolution stated that the MetLife program "works by using tax arbitrage between tax-deductible interest on policy loans and the non-taxable build-up of premium income and dividends." Ex. J543, at A010266. The description of the COLI program stated that approximately 17,800 salaried full-time U.S. employees would be covered with average earnings impact and cash flow of $10 million per year after year three and no start-up losses in any year. Ex. J543, at A010267. The description further stated that the program would have a $200 million NPV at an 8% discount rate. Ex. J543, at A010267.

On October 9, 1991, Dow's Finance Committee met and discussed the proposed MetLife COLI program, which included a slide presentation by Burdett. Burdett, Tr. at 1430-31. After Burdett's presentation, the Finance

Committee unanimously approved the purchase of the MetLife COLI program. The next day, Dow's Board of Directors approved the resolution. The COLI purchase was approved for the following Dow subsidiaries: DORINCO; Liana Limited; Admiral Equipment Company; Essex Specialty Products, Inc.; DowBrands Inc.; FilmTec Corporation; Bo ride; and DCOMCO. Stip., ¶ 102. The features of the policy purchased later were outlined in a Memorandum of Understanding (MOU) which modified the terms of the insurance contract.

4. Decision to Add Union Employees

The 1991 COLI program was initially limited to salaried employees. As an incentive to consenting to be covered under Dow's COLI program, Dow offered the beneficiaries of each participating salaried employee a $5,000 death benefit and the beneficiaries of each former salaried employee a $2,500 death benefit. Stip, ¶ 107. This death benefit would also be offered to employees covered under the Great West COLI program. *Ibid.*

By December 20, 1991, the census on the salaried employees was complete and 15,422 employees had consented. Ex. J629, at A013400-01; Burdett, Tr. at 1461. Dow's hourly union employees in Dow's Michigan Division also asked to be included in the COLI program, and Dow agreed. Burdett, Tr. at 1463; Ex. J623; Ex. J618, at H000332; Stip., ¶ 106. For the hourly employee-insureds who consented to participate in the MetLife COLI program, the beneficiaries would receive $4,000 death benefits for current hourly employees and $2,000 for beneficiaries of former hourly employees. Stip., ¶ 107.

The approximately 2,000 hourly union employees were included in the original authorization for 17,800

because the salaried employees consenting was less than 15,800 at the time and because it would be easier administratively to include them in the original program. Burdett, Tr. at 1463-64; Ex. J623, at A009332; Ex. J618, at H000332; Ex. J620, at H000333; Ryan, Tr. at 1824-25. MetLife issued a separate group policy for the hourly employees and agreed to combine the experience of both policies for the purpose of experience rating and apply the Memorandum of Understanding (MOU) to the new policy. Ex. J627, at A013041-42; Ryan, Tr. at 1824-25. The consent forms were mailed on or about December 30, 1991 and the census was completed in April 1992 with 1,641 employees consenting. Ex. J632, at B010972; Burdett, Tr. at 1465; Ex. J661; Ryan, Tr. at 1698-99.

5. Features of the MetLife Policy

MetLife issued Dow two MetLife Eight Pay Group Permanent Life Policy Forms G.2332 on the lives of 17,061 Dow employees. Stip., ¶ 109. Policy number 34181-G was issued on the 15,420 nonunion employees and policy number 34406-G was issued on the 1,641 union employees. Stip., ¶ ¶ 104, 106. The permanent life policies covered the insureds for the remainder of their lives, as opposed to a specific term or number of years. Yau, Tr. at 1977. The policies were owned by Dow and Dow was the beneficiary of the death proceeds under both policies. Stip., ¶ 110.

The policies required Dow to pay eight level annual premiums of $10,000 for each insured. Stip., ¶ 111. After the payment of eight annual premiums, the policies were considered paid-up, and no additional premiums were due. Stip., ¶ 114. The MetLife policies required the payment of the gross premium to maintain the scheduled level death benefit, which was based on the age of the insured. The age-based factor was designed to comply with IRC Section 7702,

which prescribes the minimum permissible ratio between death benefits and cash value. DesRochers, Tr. at 3345-46. Under the terms of the MetLife policy, failure to pay the annual premiums would cause the policies to lapse, subject to the nonforfeiture provisions of the policy. The policies provided certain nonforfeiture options in the event that the stated annual premiums were not paid and the policy had unencumbered cash value. Stip., ¶ 118.

MetLife maintained an accumulation fund for each of Dow's insureds. Stip., ¶ 112. For each gross premium paid by Dow, MetLife credited the accumulation fund of the individual insured with the gross premium less an expense charge of 2.057% for state premium taxes. Stip., ¶113. Interest earned was also credited to the accumulation fund while cost of insurance charges, expenses charges, and partial withdrawals were deducted from the accumulation fund. Stip., ¶ 112.

Although Dow's COLI policy was written on a group policy form, it was MetLife's position that the Dow COLI program was a series of individual policies which were administered as a collection on individual insurance contracts with the premiums, COI, cash values, loans, withdrawals, policy values, and charges computed separately in each insured's accumulation fund. Ex. J483, at 010326; Ex. *P85,* at 2; Burdett, Tr. at 1422-23; Ryan, Tr. at 1744-45; DesRochers, Tr. at 3565, 3566; Ex. J499.

On December 20, 1991, Dow and MetLife signed a Memorandum of Understanding (MOU), referenced above, dated December 18, 1991 in conjunction with the policies which set forth the administrative and technical details of how the policies were intended to operate, including adjustments to COI, retention charges, the credited rate, experience rating, and the unwind provision. Stip., ¶ 105;

Ex. J580; Rogalski, Tr. at 2526; Lake, Tr. (1/14 a.m.) at 146-47. Dow and MetLife also signed an agreement that MetLife would provide additional specialized services to Dow with respect to the MetLife COLI plan. Stip., ¶ 105.

Similar to universal life products, all the costs of Dow's MetLife COLI policies, such as COI and expense charges, were transparent to Dow. Dow was aware of four explicit costs associated with the MetLife program: (1) a 2.057% load for premium taxes, (2) the COI, (3) the spread between the loaned and credited interest rates, and (4) a 2.2% retention charge. Ryan, Tr. at 1742-43.

6. Cost of Insurance, Dividends and Mortality Charges

Based on the rate set forth in the MOU, MetLife calculated the COI for each individual employee based on his or her age and net amount of risk. The individual COI charges were totaled to determine the aggregate amount owed by Dow. Yau, Tr. at 2062-63. In response to Dow's request, MetLife agreed to a decremental spread between the loan rate and the credited rate, stated as follows in the MOU: (a) 25 basis points on the first $800 million of outstanding policy loans, (b) 20 basis points on the next $800 million of outstanding policy loans, (c) 15 basis points on the next $800 million, and (d) 10 basis points for the policy loans over $2.4 billion. Ex. J580, at CBI260.

The MOU detailed the dividend calculation and experience rating process which applied to Dow's MetLife COLI program and was to be conducted every October. Ryan, Tr. at 1785. The formulae, provided in Attachment 3 to the MOU, were based on Dow's mortality experience and applied for all policy years; they could not change absent mutual agreement of the parties. Ryan, Tr. at 1743-44, 1789;

Bartlett, Tr. at 4746-48; Ex. J580, at CBI261. In years in which the COI charges were greater than the death benefits, Dow was entitled to a dividend in the amount of the cumulative COI charges, less the incurred claims (cumulative claims plus the change in the IBNR[3] claims), less the retention charge of 2.2%. Ex. J580, at CBI264. The entire amount of the dividend was accessible to Dow and could be encumbered with a policy loan or withdrawal. Rogalski, Tr. at 2533-34.

The COI charges were adjusted in a manner that reflects both retrospective and prospective components, but once again there was no fully retrospective true-up mechanism which eliminated the risk associated with the prediction of mortality rates. For instance, the MetLife policy did not contain an imbedded margin in the COI charges to cover potentially volatile experience, Yau, Tr. at 2364; Rogalski, Tr. at 2457-58; Hickman, Tr. at 2968-69; a claim stabilization reserve to recover losses in years when the policy owner experienced deaths in excess of expectations, Yau, Tr. at 2084-85; Rogalski, Tr. at 2459, 2461; Ryan, Tr. at 1780, 1787; Sayre, Tr. at 5832-33, 5834-35; a loss carryforward provision which would give the insurance company the ability to carry its losses forward to subsequent policy years and to recoup those losses through future policy year surpluses, Rogalski, Tr. at 2456; or a "terminal" retrospective deduction which would enable the insurance carrier to call on additional COIs to cover claim losses over and above COIs that were collected by charging a deduction in the year the contract surrenders or terminates,

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[3] IBNR is a reserve of "incurred but not yet reported" claims. In calculating the dividend, MetLife included an estimate of individuals who died, but whose claims had not been reported to MetLife as of the end of the policy year. Each time a dividend was paid, the old IBNR was released and a new IBNR was created. Yau, Tr. at 2087-88; Ryan, Tr. at 1784-87.

Rogalski, Tr. at 2458. All of these are common features in fully experience-rated group policies.

Rather, Dow's retrospective experience rating mechanism, set forth in Attachment 3 of the MOU, had three significant components: (1) in years when Dow paid out more in COI than it received back in death benefits, MetLife paid Dow a dividend as noted above; (2) in years when Dow received more in death benefits than it paid in COI, MetLife had the right to collect from Dow up to an additional 15%; and (3) Dow paid an annual charge of 2.2% of actual claims up to 115% of expected claims for the risk that MetLife assumed. Ex. J624, at A000570. The pricing was established by MetLife's actuary, Joseph Yau. Yau used the mortality experience which Gary Lake had complied from Dow's group term life program after comparing it to a standard mortality table, the New York Table Y, which was based on data complied by the New York Insurance Department. Yau considered Lake's actuarial study to be preferable to a standardized mortality table alone. Yau then converted the mortality rates into monthly COI rates, and then set the stop loss amount in accordance with accepted actuarial principles. The stop loss at 115% of expected claims transferred risk to MetLife that the actual claims experience could result in a mortality profit to the policyholder. The amount paid to MetLife by Dow, the 2.2% retention charge, was reasonable in light of the risk calculated by Yau.

Based on the experience rating formula, MetLife paid dividends to Dow as follows:

Policy Year Beginning	Dividends (In Thousands)
10/29/91	$3,873
10/29/92	$2,683
10/29/93	$2,903
10/29/94	$3,623
10/29/95	$2,711
10/29/96	$0
10/29/97	$9,111
10/29/98	$3,842
10/29/99	$1,978
TOTAL	$30,723

Stip., ¶ 131. The dividend for the 1997 policy year was substantially higher than dividends paid to Dow in other policy years because it included a refund of Deferred Acquisition Cost (DAC) taxes paid by Dow to MetLife. Ex. J998, at A002883; Yau, Tr. at 2257-58; Rogalski, Tr. at 2520. The 1997 dividend also included an adjustment to the IBNR reserve.[4] Bartlett, Tr. at 4802-04; Ex. J905.

The MOU also provided that, if mortality experience was higher than anticipated, MetLife could increase the COI charges; this is a form of prospective experience rating. Yau, Tr. at 2310; Bartlett, Tr. at 4813. MetLife could not change the COI charges for the first two policy years and could only change the COI charges in the third year if the actual mortality experience in each of the first two years exceeded 125% of the annual COI charges. Ex. J580, at CBI257. Beginning in the fourth year, MetLife had the right to change the COI charges as long as the COI charges did not exceed the average mortality experience over the prior three policy years and did not exceed the maximum COI

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[4] The IBNR reserve refers to funds set aside to cover claims in the policy period that were "incurred but not reported."

charges contained in the policy form. *Ibid;* Ex J593, at A014138. MetLife did not interpret its "right" to change COI charges in and after the fourth year as requiring it to decrease COI charges in the event that the prior years' mortality experience was lower than the current mortality charges. Yau, Tr. at 2311-12.

7. Loan Mechanism and Rate Formula

Dow's MetLife COLI policies provided for policy loans secured by the value of the accumulation fund for each of the covered employees. Stip., ¶ 115. The maximum loan rate under Dow's group MetLife policies was the greater of Moody's Corporate Bond Yield Average or the credited loaned interest rate plus no more than 0.77% in policy years one through eight and 0.25% in policy years nine and later. Stip., ¶ 116. The actual policy loan rate was always equal to or less than Moody's Corporate Average. Stip., ¶ 116.

Dow's MetLife COLI policies provided for a variable policy loan interest rate based on the Moody's Corporate Bond Yield Average—Monthly Average Corporate as published by Moody's Investors Service, Inc. Stip., ¶ 119. Dow's MetLife COLI policies also provided for a fixed loan interest rate of 8%. Stip., ¶ 120. Dow had the right to choose the fixed or variable rate each year. Stip., ¶ 121. The loan interest rates charged by MetLife were as follows:

Policy Year Ending	Loan Interest Rate
10/29/92	9.42%
10/29/93	8.44%
10/29/94	7.50%
10/29/95	8.42%
10/29/96	7.66%
10/29/97	7.66%
10/29/98	7.66%
12/29/98	6.75%
Effective 12/30/98	4.25%
10/29/00	4.25%
3/29/01	4.25%
Effective 3/30/01	4.25%

Stip., ¶123.

Under the Generally Accepted Accounting Principles (GAAP), policy loans obtained from MetLife were netted against policy values on the asset side of the balance sheet and were not shown as a separate liability for financial reporting purposes. Stip., ¶ 124.

Under the MetLife COLI policies, the rate credited to Dow's accumulation fund would never be less than 4% compounded annually. Stip., ¶ 128. Under the policy, the "credited unloaned interest rate," the interest rate credited on the unloaned portion of the accumulation fund, was set by MetLife from time to time. Stip., ¶128. The "credited loaned interest rate," the interest rate credited on the loaned portion of the accumulation fund, was equal to the greater of (1) Moody's Corporate Bond Yield Average—Monthly Average Corporate for the calendar month ending two months before the start of the policy year minus up to 0.77% in policy years one through eight and minus up to 0.25% beginning in policy year nine; (2) the credited unloaned interest rate in effect on the first day of the calendar month

ending two months before the start of the policy year; or (3) the guaranteed interest rate of 4%. Stip., ¶ 129. The actual credited loaned interest rate and credited unloaned interest rate for the MetLife COLI policies was as follows:

Policy Year Ending	Loaned Credited Rate	Unloaned Credited Rate
10/29/92	8.65%	5.50%
10/29/93	7.67%	4.00%
10/29/94	6.73%	4.00%
10/29/95	7.65%	4.93%
10/29/96	6.89%	5.29%
10/29/97	6.89%	4.50%
10/29/98	6.89%	5.16%
12/29/98	6.50%	4.78%
Effective 12/30/98	4.00%	4.78%
10/29/00	4.00%	5.00%
3/29/01	4.00%	5.00%
Effective 3/30/01	4.00%	6.81%

Stip., ¶ 130.

Section 3 of the MOU provided specific guarantees regarding Dow's right to unwind the policies in the event of "adverse tax legislation," defined as "a change in the tax law that would disallow the loan interest deduction on a prospective basis or legislation or regulation that has an adverse impact on the Corporate Owned Life Insurance purchased by Dow and Dow's COLI plan design." Ex. J580, at CBI252; Ex. J565, at A014202. If unwind occurred during the first policy year, MetLife would return the gross premium plus interest, less claims paid plus interest, less policy loans plus interest, less interest adjustment for state premium tax and DAC tax paid. If unwind occurred after the first policy year, MetLife would apply the first-year procedure to the current policy year and then pay the

surrender value as of the last day of the prior policy year. Ex. J580, at CBI253.

8. Ayco

Although Clark/Bardes was initially involved in promoting the MetLife policy to Dow and actively sought to become Dow's broker of record, Dow's MetLife COLI policies were administered by Ayco pursuant to two Administrative Service Agreements, one for each of the two group contracts. Stip., ¶ 97, 133. Under the terms of the agreements, with an effective date of October 30, 1991, Ayco agreed to perform a number of administrative tasks for Dow, including tasks related to the implementation of the policies and tasks related to the on-going management of the policies. Stip., ¶ ¶ 133-34. For Ayco's management of the enrollment and consent process, Dow agreed to pay Ayco $3.75 for each Dow insured to (1) prepare and mail consent forms to employees eligible for coverage under Dow's MetLife COLI program for the purpose of acquiring insurance on their lives, (2) maintain a toll-free telephone number for eligible employees to call with respect to inquiries relevant to the insurance being purchased by Dow on their lives, (3) follow up with eligible employees delinquent in submitting consent forms, and (4) coordinate services with MetLife regarding the issuance and processing of Dow's MetLife COLI policies. J634, at A009690-91; Burdett, Tr. at 1462.

In exchange for ongoing management of the policies, Dow agreed to pay Ayco an "annual fee" of $50,000, due on or before October 30 of each year, to (1) consult regarding GAAP to ensure that proper accounting methods for the MetLife COLI policies are used, (2) provide annual reports that summarized past performance of the MetLife COLI policies and projected future performance, (3) prepare

composite data for detailed projections and composite illustrations, (4) arrange and process policy loans and withdrawals with MetLife, (5) compute policy values and expenses to insure that MetLife's calculations were correct, and (6) assist Dow and MetLife in processing death claims and the payment of death proceeds. Ex. J634, at A009691; Burdett, Tr. at 1672-73; Ex. J622, at A013070. The annual fee was adjusted each year by a cost of living increase that was the lesser of the annual change in the Consumer Price Index as calculated on June 30 of applicable year, or 105% the prior year's annual fee. Stip., ¶ 136. In addition, Dow agreed to pay Ayco an annual "service fee" of $75 per insured on the first 500 insureds, $50 per insured on the next 500 insureds, $25 per insured on the next 2,000 insureds, $15 per insured on the next 2,000 insureds, and $10 per insured on the remaining insureds. The first service fee was due on December 31, 1991. Thereafter, the service fee was payable in quarterly installments on October 30, January 30, April 30, and July 30. Stip., ¶ 137. For tax year 1991, Dow paid a total of $174,506 to Ayco.

9. Effective Policy Date

It was originally assumed that Dow's MetLife policies would have an effective date of December 1991, the month when the census of the salaried employees was expected to be finalized. Lake, Tr. (1/16 a.m.), at 495-96; Ex. J555, at A010294. On October 9, 1991, however, it was recommended that Dow change the effective date to October 1991 to have a higher policy loan interest rate (9.42% instead of 8.91%); MetLife was willing to "backdate" the policies even if the census was not finalized until December. Ex. J555, at A010294; see *also* Lake, Tr. (1/16 a.m.) at 496-97; Yau, Tr. at 2215-16. On October 30, 1991, Dow executed an application for Eight Pay Group Permanent Life Insurance with MetLife and paid the net premium due of

$12,505,613.14. Sayre, Tr. at 5816; Ex. J581; Stip., ¶ 103. The premium represented all potentially eligible lives (18,548). Ex. J565, at A014203; Burdett, Tr. at 1459-60. Dow received a refund for the salaried employees who did not consent by December 31, 1991. Burdett, Tr. at 1461.

Both of the MetLife COLI policies had an effective date of October 30, 1991.

On December 23, 1991, when Dow decided to add union employees to the COLI program and policy number 34406-G was issued to cover the unionized employees, the preliminary census yielded 2,161 eligible union employees; a re-estimated census on January 14, 1991 yielded 2,199. Sayre, Tr. at 5818; Ex., J643. Ultimately, 1,641 union employees returned consent forms by May 5, 1992 and the census was finalized. Sayre, Tr. at 5818-19; Ex. D685.

10. Post-Purchase Illustrations

After the Dow Board of Directors approved the resolution authorizing the purchase of the MetLife plan in October 1999 through the completion of the census in March 1992, MetLife and Winkelvoss ran several illustrations based on the estimated total population of Dow's program. Exs. D240, D622, D627, D682, J604, D641; Yau, Tr. at 2269-78; Sayre, Tr. at 5787-89; Ex. D840. The Winklevoss illustrations did not cap loans at $50,000 because, according to John Ryan, MetLife's vice-president, (1) it was administratively easier to and less costly to run illustration for a single scenario (which happened to be uncapped loans) and (2) Dow had already made its purchase decision based on prior illustrations. Ryan, Tr. at 1826-28.

Reillustrations were also provided by Ayco. Burdett stated that these reillustrations were prepared to help Dow

manage and track the *current* performance of the program; therefore, whether the loans were capped at $50,000 or not affected only year 17 and later was irrelevant to current performance. Burdett, Tr. at 1676.

11. Payment of the Premiums

a. Policy Loans

Dow's MetLife COLI policies provided for policy loans secured by the value of the accumulation fund for each of the covered employees. Stip., ¶ 115. The loan value was equal to the cash surrender value of the policy at the date of the policy year, less any unpaid premiums or loan interest payable to the end of the policy year. Ex. J409, at 14; Ex. J593, at A014131; Ex. J408, at A00591; Yau, Tr. at 2081-82. The maximum policy loan was calculated such that when cash inflows and outflows for the remainder of the year were considered, there was a non-negative cash value remaining. Yau, Tr. at 2081-82. The policy loans could be repaid at any time and if not repaid before death were to be repaid from death benefit proceeds. Ex. J408, at A000589, A000592; Ex. J409, at 12, 15. Each of Dow's loans from MetLife required the payment of interest in arrears on the policy anniversary date. Stip., ¶ 117. Policy Form G.2332 provided for certain nonforfeiture options in the event that the stated annual premiums were not paid and the policies had unencumbered cash value. Stip., ¶ 118. The policy provides that "[f]ailure to repay a loan or to pay loan interest will not result in Discontinuance of the Policy unless the Cash Surrender Value is insufficient to pay the Monthly Deduction due on a Monthly Date. In that case, the Group Policy will terminate." Ex. J408, at A000592; Ex. J409, at 15.

Dow took policy loans totaling $50,000 per policy to pay premiums for the first, second, third, eighth, and ninth

policy years. The policy loans and premium payments in the MetLife COLI program were achieved by means of netting transactions. Ryan, Tr. at 1909-14; Ex. J555, at A010295. Dow did not obtain policy loans under its MetLife COLI policies in years four through seven. Stip., ¶ 125. Dow also did not obtain policy loans in excess of $50,000 per insured employee under its MetLife COLI policies. Stip., ¶ 126. The MetLife COLI policies did not go into nonforfeiture status during the first five policy years. Stip., ¶ 127.

b. Partial Withdrawals

Dow's MetLife COLI policies also provided Dow the right to request a partial cash withdrawal from the available cash value. Ex. J580, at CBI254; Ex. J593, at A014130. A partial withdrawal would reduce individual accumulation funds on a dollar-for-dollar basis except during the first ten policy years. Ex. J408, at A000590; Ex. J409, at 13. A partial withdrawal made in the first ten policy years would not affect the death benefit until the tenth policy anniversary. Ex. J593, at A014130; Ex. J580, at CBI254. The methodology for calculating the maximum partial withdrawal was the same as for the maximum policy loan: MetLife determined the current cash value, cash inflows and outflows to the policy, and determined the maximum withdrawals such that the end of the year cash value would not be negative. Yau, Tr. at 2081-82. Dow used partial withdrawals to finance premiums in years four and five to finance premiums and policy loan interest and years six and seven to finance policy loan interest.

The premium payment and partial withdrawals were also achieved by means of a simultaneous netting transaction. This was somewhat problematic because at the end of each policy year, the cash values were fully encumbered, as with the Great West policies. However, in

the fourth through seventh policy years, MetLife deemed the annual premium paid, thereby creating additional cash value. That "new" value then supported the partial withdrawals which were considered to have paid approximately 90% of the premium and accrued loan interest. The balance of the premium was paid in cash.

c. Loading Dividends

MetLife determined that the use of a loading dividend structure was an inappropriate mechanism to pay premiums in years four through seven and comply with I.R.C. § 264. Dow's MetLife COLI program did not provide for loading dividends.

12. Performance of the Policies

The table below reflects Dow's operation of its MetLife policies over the first seven years:

MetLife Cash Payment—Aggregate (In Thousands)						
Year	Premium	Policy Loan	Policy Loan Interest	Dividend	Withdrawal	Dow Cash Payment
10/30/91	$170,510	$158,756	0	0	0	$11,754
10/30/92	$170,250	$175,540	$14,990	0	$10	$9,690
10/30/93	$170,000	$175,278	$27,367	0	$10,695	$11,395
10/30/94	$169,770	0	$38,132	0	$195,779	$12,123
10/30/95	$169,360	0	$42,737	0	$200,071	$12,026
10/30/96	0	0	$38,894	0	$28,665	$10,229
10/30/97	0	0	$38,676	0	$25,065	$13,611
10/30/98	0	0	$38,575	0	$35,559	$3,016
TOTAL	$849,890	$509,574	$239,371	0	$495,844	$83,844

Stip., ¶ 132.

H. Disposition of the Policies

In August 1996, Congress enacted the Health Insurance Portability and Accountability Act of 1996

(HIPA), Pub. L. 104-191, § 501, 110 Stat. 1936. HIPA amended I.R.C. § 264 to disallow policy loan interest deductions under broad-based COLI programs with one exception effective January 1, 1996. The exception allowed COLI policy loan interest deductions that were otherwise deductible under prior law to continue for up to 20,000 employees through the 1998 tax year. However, only 90% of the interest was deductible for the 1997 tax year, and only 80% of the interest was deductible for the 1998 tax year.

Because they believed that HIPA would substantially change the performance of Dow's COLI policies, both Clark/Bardes and Ayco proposed mechanisms for Dow to phase-out its COLI policies. Wimberly, Tr. at 4506-07; Jenkins, Tr. at 4538-39; Exs. J1013, J1057, J1064, J1041, J1042, J1059. Based on the brokers' initial illustrations, Stefan Koch, a finance manager in Dow's corporate treasury group, assessed the financial performance of the COLI programs. Koch requested additional illustrations to reflect four alternatives: (1) surrender the policies and prepay all the loans; (2) withdraw to basis and prepay part or all of the loans; (3) maintain the policies and prepay part or all of the loans; (4) maintain the policies and loans as is. Ex. J1169; Koch, Tr. at 2592, 2594; Exs. J236, J238, J1041, J1042, J1059, J. 1057; Koch,Tr. at 2598-2601, 2609, 2614-15, 2616, 2628, 2631.

Koch recommended that Dow maintain the Great West COLI policies "as is" because the high cash values would maintain the death benefits as a high level, resulting in a favorable financial impact in terms of cash flows and earnings. Koch, Tr. at 2611; Ex., J1169, at B014286. Koch discounted the cash flows using two interest rates: (1) Dow's Weighted Average Cost of Capital (WACC), which was at 10.75% at the time, and (2) Dow's Cost of Funds (COF), which was at 4.03% at the time. Exs. P199, J1057,

J1169; Koch, Tr. at 2602, 2603-05, 2611, 2613. Using the COF, Koch projected Dow would receive a positive cash flow on a NPV basis of $75.9 million over the life of the Great West COLI program. Ex. P199. Koch projected earnings of $6.5 million in 1999, $7.2 million in 2000, and $8 million in 2001 by keeping the policies "as is." *Ibid.* An independent analysis by Clark/Bardes also concluded that leaving the Great West COLI policies in force and capping the loans at $50,000 would yield the best financial performance based on a present value basis. Wimberly, Tr. at 4507-10; Exs. J1057, J1013, J1064. The government contends that the death benefit projections were overstated and thus would cause economic losses to Great West. Those losses, the government argues, would cause Great West to adjust the spread and reduce or eliminate the cash flows to Dow – a factor not taken into account by Koch in his analysis. *See* Koch, Tr. at 2634-35, 2637-39; Exs. J328, 1057. In November 1998, Dow adopted Koch's recommendation and decided to keep the Great West COLI policies in force. Koch, Tr. at 2613.

For the MetLife COLI program, Dow elected to discontinue premiums after the fifth policy year. Stip., ¶ 132. Therefore, the only amount due each subsequent year was the accrued policy loan interest. *Ibid.* Koch recommended that Dow take partial withdrawals to basis and pay off outstanding loans through netting transactions. Koch's recommendation would have generated a $37.2 million net cash flow when discounted at the 4.03% COF rate and a $8.7 million net cash flow when discounted at the 10.75% WACC rate. Ex. J1169, at B014282. Short-term earnings, however, were superior if Dow kept the MetLife COLI policies "as is." Under the "as is" strategy, Dow could expect positive earnings of $3.3 million in 1999, $6.5 million in 2000, and $6.9 million in 2001. Long term, Dow could expect a negative cash flow of $10.9 million when

discounted at the 4.03% COF rate and a negative cash flow of $68.2 million when discounted at the 10.75% WACC rate. Koch, Tr. at 2627-18; Ex. J1169, at B014282. Pedro Reinhard, Dow's Chief Financial Officer, rejected Koch's recommendation and decided to keep the MetLife COLI policies "as is" because the earnings profile was better. Koch, Tr. at 2627-18; Ex. J1169, at B014282.

I. Dow's Filing of Tax Returns, Challenges, Payment of the Tax, and Claim

Dow timely filed its corporate federal income tax returns for the 1989, 1990 and 1991 calendar years with the IRS's Detroit, Michigan office and paid the tax shown on the return. Stip., ¶ 6. The IRS assessed an income tax deficiency against Dow of $1,367,383 for 1989; $3,043,326 for 1990; and $6,836,910 for 1991. On March 12, 1999, Dow paid these deficiencies together with interest in an amount totaling $22,209,570:

	1989	1990	1991
Federal Income Tax	$1,367,386	$3,043,326	$6,836,910
Assessed Interest	$1,781,778	$3,235,630	$5,944,540
TOTAL	$3,149,164	$6,278,956	$12,781,450

On December 22, 1999, Dow timely filed form 1120X, claiming a refund for tax years 1989, 1990, and 1991. For tax year 1989, Dow is claiming a refund of the deficiency and assessed interest, totaling $3,149,164, based on Dow's position that it was entitled to deductions in the amounts of (1) $3,843,813 from interest payments made on loans secured by Dow's COLI policies and (2) $168,563 from consulting fees paid by Dow for the administration of its COLI policies to Clark/Bardes. For tax year 1990, Dow is claiming a refund of the deficiency and assessed interest,

totaling $6,278,956, based on Dow's position that it was entitled to deductions in the amounts of (1) $12,968,778 from interest payments made on loans secured by Dow's COLI policies and (2) $2,175,160 from consulting fees paid by Dow for the administration of its COLI policies to Clark/Bardes. For tax year 1991, Dow is claiming a refund of the deficiency and assessed interest, totaling $12,781,450, based on Dow's position that it was entitled to deductions in the amounts of (1) $13,491,825 from interest payments made on loans secured by Dow's COLI policies, (2) $181,715 from consulting fees paid by Dow for the administration of its COLI policies to Clark/Bardes, and (3) $174,506 from consulting fees paid by Dow for the administration of its COLI policies to Ayco.

The IRS issued full disallowances of Dow's 1989, 1990, and 1991 claims for refund on May 23, 2000. Dow timely filed this action, claiming a refund of the federal income tax and assessed interest for tax years 1989, 1990, and 1991 on the basis of the deductions taken, as described above.

II. Analysis

Dow claims that it is entitled to deductions for interest payments on policy loans in the years after 1989 for the Great West COLI plan and after 1991 for the MetLife COLI plan. Generally, for corporations, "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." IRC § 163, 26 U.S.C. § 163(a). For the purpose of the Internal Revenue Code, "interest" represents compensation or consideration for the use or forbearance of money. *Old Colony R.R. Co. v. Comm'r*, 284 U.S. 552, 561-62 (1932). "Indebtedness" under IRC § 163 consists of "an unconditional and legally

enforceable obligation for the payment of money." *Autenreith v. Comm'r,* 115 F.2d 856, 858 (3d Cir. 1940).

The taxpayer bears the burden of proving the validity of its claimed deductions. *National Starch & Chem. Corp. v. Comm'r,* 918 F.2d 426, 429 (3d Cir. 1990) *aff'd sub nom INDOPCO, Inc. v. Comm'r,* 503 U.S. 79 (1992).

Where the interest payment is made on a loan secured by a life insurance policy, special rules apply. These rules have evolved as Congress has attempted to keep pace with insurance industry development of various whole life and universal life products utilized by corporations as investment and revenue producing vehicles. For several years, many businesses have purchased insurance on the lives of its key employees in order to protect the company from the economic loss that might result from the untimely death of a person important to the success of the business. When the form of the insurance policy was one which allowed for the accumulation of cash value, such as whole life or universal life, borrowing against the policy value to pay the insurance premiums became prevalent. See *Woodson-Tenent Labs., Inc. v. United* States, 454 F.2d 637 (6th Cir. 1972). Interest paid on these loans secured by the cash value of the life insurance policies was deductible under the Internal Revenue Code. As noted above, Congress limited the practice of leveraging premium financing by enacting the "4-of-7 rule," confining the interest deduction to loans of $50,000 or less, and ultimately phasing out the interest deduction after 1996. *See* Pub. L. 88-272 (1964); Pub. L. 99- 514, § 1003, 100 Stat. 2085 (1986); Health Insurance Portability and Accountability Act of 1996, (HIPA), Pub. L. No. 104-91, 110 Stat. 1936 (1996).

The interest deductions claimed by the plaintiff in this case predate the phase-out effectuated by HIPA.

However, undergirding the application of IRC § 264 is an additional statutory provision which defines "life insurance" as "any contract which is a life insurance contract under the applicable law," and which also meets certain actuarial rules relating to the ratio of the investment portion of the life insurance contract to the pure insurance element. *See* IRC §§ 7702, 7702A.

In this case, Dow claims that the COLI plans complied with chapter and verse of the relevant IRC sections which render the interest payments made in connection with its COLI plans' deductible. Dow also claims that, pursuant to IRC § 162(a), the expenses it incurred in developing both of the COLI plans are deductible as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on [its] trade or business."

The government has disallowed Dow's claimed deductions for several reasons. First, the government claims that the Great West and MetLife COLI plans were devoid of economic substance because there were no practical economic effects of the transactions except to create income tax deductions. Accordingly, the government claims that both of the COLI plans were shams in substance, or economic shams.

Second, the government attacks the use of simultaneous netting transactions by Dow to pay premiums on the policies in the first eight years of their existence, reasoning that the premium payments never really occurred because they were factual shams. The government contends that, consequently, the interest deductions are claimed on sham loan transactions, and the plans fail the 4-of-7 test of IRC § 264(c)(1) because the use of policy withdrawals to

pay premiums constituted nothing more than circular transactions without factual substance.

Third, the Great West COLI plan is under attack by the government as not qualifying as "life insurance" under IRC § 7702 for the reason that the plan does not constitute a life insurance contract "under the applicable law," that is, under Michigan law.[5] The government contends that Dow did not have an insurable interest in the lives of all of the 4,051 employees insured under the Great West plan, as that concept is defined under the common law of Michigan, and therefore Dow is not entitled to the favorable tax treatment afforded life insurance contracts, including the deductibility of policy loan interest, afforded under the Internal Revenue Code.

Fourth, because both Great West and MetLife issued insurance binders upon payment of the first year premiums, but did not deliver the policies until a much later date after the final census was transmitted to the respective insurance companies, the government claims that the insurance policies were effectively backdated and that interest and expense deductions for the interim period must be disallowed.

Finally, the government contends that, because the COLI programs were economic shams, any business expenses incurred in implementing the programs are not deductible.

A. The Sham Transaction Doctrine

There is no question that a taxpayer is entitled to reduce tax obligations by any means allowed by the law. *See*

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[5] The government also asserts, belatedly, that the Court must consider the same question under Texas and Louisiana law because a significant portion of Dow's insured workforce resided in those states.

Gregory v. Helvering, 293 U.S. 465, 469 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."). However, transactions that are invented solely to create tax deductions and otherwise have no economic substance, even though formally complying with the letter of the Internal Revenue Code, will not be recognized. *See Knetsch v. United States*, 364 U.S. 361, 365-66 (1960). Such transactions are deemed "shams" and will not support tax deductions where their substance is not consistent with their form. *ACM Partnership v. Comm'r*, 157 F.3d 231, 247 (3d Cir. 1998).

Discussions of the sham transaction doctrine typically begin with *Gregory v. Helvering*, where the Supreme Court found that a transaction that was devoid of any real business purpose and designed solely to avoid the payment of taxes was a nullity for federal income tax purposes. In that case, Evelyn Gregory, the sole shareholder of United Mortgage Corporation, sought to transfer to herself one thousand shares of Monitor Securities Corporation held as an asset by United Mortgage. To achieve that objective, Gregory formed Averill Corporation, of which she was the sole shareholder, and caused United Mortgage to transfer the Monitor Security stock to Averill as Averill's sole asset. A few days later, Averill was dissolved and liquidated by distributing its assets – i.e., the Monitor Security stock – to Gregory. She then immediately sold the stock for $133,333, declaring a capital gain of $76,000 on which she paid tax. However, her tax would have been much higher if United Mortgage had sold the Monitor stock and distributed the proceeds to her. *Gregory*, 293 U.S. at 467.

The Commissioner of Internal Revenue disregarded the corporate reorganization and imposed a tax as if United Mortgage had sold the stock and paid Gregory a dividend.

That decision was upheld by the court of appeals, and the Supreme Court affirmed. The Court drew a distinction between the purposeful but legal avoidance of taxation, which it found to be proper, and the creation of a device that is not what it purports to be. Although the corporate reorganization in this case followed the statutory requirements to the letter, it created

> an operation having no business or corporate purpose – a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose: it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death . . . .
>
> The rule which excludes from consideration the motive of tax avoidance is not pertinent in this situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Id. at 469-70.

Thus, the Supreme Court set forth an analytical framework for detecting shams which first calls for an examination of the transaction objectively to determine its economic substance irrespective of taxpayer motivation to avoid taxation. *Id.* at 470.

The Supreme Court applied the same analysis *in Knetsch v. United States,* a case dealing with the tax arbitrage opportunities presented by the deductibility of policy loan interest. The policies at issue in that case were ten thirty-year annuity policies which Karl Knetsch purchased, each with a face value of $400,000 earning 2.5% interest compounded annually, at a price totaling $4,004,000. Knetsch paid the purchase price with $4,000 in cash and a non-recourse note in the amount of $4,000,000 at 3.5% interest. The note was secured by the annuity policies. The annuities included loan privileges which allowed Knetsch to immediately borrow amounts secured by the value in excess of his indebtedness. The cash value of the annuities at maturity (when Knetsch would have been ninety years old) would have been $8,388,000 paying $90,171 monthly. *Knetsch,* 364 U.S. at 364.

On the same day he bought the annuities, Knetsch paid the first year's interest on the notes in the amount of $140,000. Five days later, Knetsch borrowed $99,000 secured by the excess policy cash value, leaving the annuities with excess cash value of $1,000. On his tax return for that year, Knetsch deducted $143,465 from gross income as "interest paid . . . within the taxable year on indebtedness" pursuant to § 23(b) of the 1939 tax code. Knetsch repeated this practice in the second and third contract year, stripping policy values by borrowing, and deducting interest payments on his tax returns. He cancelled the contract sixteen days after the fourth contract year began. The total cash value of the annuities at the time was $4,308,000 and the total

indebtedness was $4,307,000. Knetsch surrendered the annuities and received $1,000 in cash. *Ibid.*

The Commissioner of Internal Revenue disallowed Knetsch's tax deductions on each of his three returns, and Knetsch brought suit for a refund after he paid the deficiencies. The lower courts found that there was no economic substance to the transaction, and the Supreme Court affirmed that decision. Once again, the Supreme Court noted the irrelevance of the Commissioner's contention that the taxpayer's sole motive was to gain taxable benefits. The Court reaffirmed that "the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. . . . But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." *Id.* at 365 (citing *Gregory,* 293 U.S. at 469). In examining "what was done," the Court concluded that the series of transactions was a sham. The taxpayer paid $294,570 during the first two years in premium and received $203,000 back in the form of "loans." Although in exchange for this out-of-pocket difference, the taxpayer ostensibly had a monthly annuity payment coming of $90,000 at maturity, the Court noted that this "was a fiction, because each year [the taxpayer's] annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000." *Id.* at 366. It was obvious to the Court, therefore, that the "transaction with the insurance company did not appreciably affect his beneficial interest except to reduce his taxes." *Id.* (internal quotes and citation omitted). The Court did not condemn all transactions of this type, however, and focused on its fact-specific analysis. "There may well be single-premium annuity arrangements with nontax substance which create an

'indebtedness' for the purposes of § 23(b) of the 1939 Code and § 163(a) of the 1954 Code. But this one is a sham." *Id.*

In the three previous challenges to highly-leverages COLI plans, the government successfully argued that the insurance plans were devoid of economic substance and their sole economic purpose was to provide a platform for loans which generated interest deductions. However , insurance policy loan interest deductions were allowed against a sham challenge to a form of COLI in *Campbell v. Cen-Tex, Inc.*, 377 F.2d 688 (5th Cir. 1967). In that case, Cen-Tex had established a deferred compensation plan for members of its board of directors that would pay monthly benefits to surviving spouses and dependents for ten years. To finance the plan, the corporation purchased life insurance on the lives of five board members, prepaying the first five annual premiums (which were substantially front-loaded) and borrowing against the policy loan values to finance those premium payments. After the Commissioner disallowed the interest deductions, the taxpayer successfully sought a refund in the district court, which found that borrowing against policy loan values and the prepayment of premiums were in pursuit of a substantial business purpose. The court of appeals, affirming, noted that the transactions literally fit through a loophole that existed in the tax code. The government's response, the court observed, was to offer the sham transaction doctrine as a "thumb-in-the-dike to thwart the use of tax escape devices." *Id.* at 691. In comparing the plan in that case to the annuities in *Knetsch,* the court found that after twenty years there were potential death benefits and cash surrender values that exceeded the maximum loans beyond the "relative pittance" of Knetsch's $1,000. The Court concluded:

> It cannot be denied that the tax incidence was important to Cen-Tex and an inducement to

> casting the transactions into the form which they took. But for Cen-Tex it must be said that the tax saving result of the transaction was not the sole motive and purpose for entering into it. The policies purchased provided for a beneficial interest. The transaction was not without economic value, economic significance, economic substance, or commercial substance.

Id. at 693 (footnotes omitted).

The Court of Appeals for the Sixth Circuit adopted the *Cen-Tex* reasoning in *Woodson-Tenent Laboratories, Inc. v. United States*, 454 F.2d 637 (6th Cir. 1972), in which the court affirmed a judgment ordering a refund for disallowed interest deductions. There, the corporation took substantial loans against policy cash value to finance the premiums for "key man" COLI. The court rejected the sham argument, finding economic substance in the transactions which actually occurred.

Courts have identified two types of sham transactions: 1) "shams in substance," also referred to as "economic shams," in which the transactions "actually occurred but . . . lack the substance their form represents;" and 2) "[s]hams in fact" in which the reported transactions really never occurred. *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989). The government contends that the COLI plans at issue are economic shams, and that they possess features which are shams in fact.

1. Shams in Substance

Economic shams, or shams in substance, are assessed in this Circuit by application of a test involving both an

objective and a subjective component. *See Rose v. Comm'r*, 868 F.2d 851, 854 (6th Cir. 1989) (citing *Mahoney v. Comm'r*, 808 F.2d 1219 (6th Cir. 1987)). The Court first examines the transaction to determine whether it "has any practicable economic effects other than the creation of income tax losses." *Bryant v. Comm'r*, 928 F.2d 745, 748 (6th Cir. 1991) (quoting *Rose*, 868 F.2d at 853). Although the taxpayer's subjective intent may be "relevant to this inquiry," *Rose*, 868 F.2d at 853, it is neither controlling nor dispositive at this level of the inquiry, since the objective component focuses on the transaction, not the taxpayer. *Thomas v. United States*, 166 F.3d 825, 834 (6th Cir. 1999) (quoting *Illes v. Comm'r*, 982 F.2d 163, 166 (6th Cir. 1992)). Thus, the Court may inspect the transaction to determine if the form is consistent with the taxpayer's avowed purpose for engaging in it. The taxpayer's intent provides the context; to meet its burden, the taxpayer must articulate a legitimate business purpose for placing its assets at risk. For example, a taxpayer who states that it seeks to generate an immediate stream of current income but enters into a transaction which is structured to return only long-term gains will have a basic difficulty in proof. The objective component calls for an examination of the structure of the transaction to determine if its form mirrors its substance. The question is whether the transaction has *any* economic purpose other than to generate tax deductions. *Bryant*, 928 F.2d at 748. Of course, the business purpose must also "fit" in some fashion into the subjective goals as articulated by the taxpayer. Thus, courts have held that a proper business purpose alone will not "breathe substance" into a transaction that objectively has no reasonable prospect of profitability absent tax considerations. *AEP*, 136 F.Supp. 2d at 791-92 (quoting *Winn-Dixie*, 113 T.C. at 287). Likewise, a business purpose which is markedly inconsistent with the form of the transaction chosen will cast doubt on the *bona fides* of the taxpayer.

If the transaction is objectively economically viable, the Court must determine whether the taxpayer had a legitimate profit motive in entering into the transaction. However, the subjective component does not become determinative unless the transaction has satisfied the objective requirement of the sham test. *Illes*, 982 F.2d at 165.

> [T]he question of whether a transaction has economic substance is a threshold issue designed to winnow out the most abusive tax shelters without engaging in the more difficult question of whether a transaction was profit-motivated. Therefore, in determining whether a transaction was a sham, the court should not address whether, in the light of hindsight, the taxpayer made a wise investment. . . . Instead, the court must address whether the taxpayer made a *bona fide* investment at all or whether he merely purchased tax deductions.

Bryant, 928 F.2d at 749.

Like it did in the other COLI cases, the United States contends that Dow's plans with both Great West and MetLife are economically empty transactions whose worth to Dow comes solely from the tax deductions. According to the government, under neither plan could Dow expect to benefit financially from proceeds generated by the plans' tax-free inside build-up or from the payment of death benefits, since the plans were designed to be "mortality neutral." The government argues that Dow intended to operate the plans on a minimum cash outlay strategy, so that in no year would there be positive cash flow absent the tax deductions for policy loan interest, and at certain discount rates there would be a negative net present value without the tax deductions.

The Court will examine the arguments separately as to each of the two plans.

a. Great West COLI Plan

In the previous three COLI cases, the government contended that the courts could find that the plans were economic shams by comparing the pre-tax performance with after-tax performance, which demonstrated that the plans were a losing proposition without the tax deductions. It makes the same argument here. However, unlike the other cases, there are prepurchase illustrations that show positive cash flow coming from the plan even without the tax deduction for policy loan interest. In the case of the Great West plan, the government insists that these illustrations are not reliable because the illustrations are flawed, and they rely on a payment strategy which Dow would not likely adopt because it would require the infusion of significant amounts of cash in the middle years of the plan. Moreover, even these illustrations show that the plan yielded negative cash flow without the tax deductions in the first eighteen years and, on a net present value basis, over the life of the plan. Alternatively, the government urges the Court to conclude that the insurance plan was "mortality neutral" so that Dow could not profit from the payment of death benefits, and that Dow intended to strip all excess cash from the plan, thus precluding profitability from inside build-up.

i. Illustrations

Insurance policy illustrations are, essentially, predictions of the future financial performance of the transaction. They are based on certain assumptions concerning mortality rates and financial returns, which may or may not eventuate. The government points to the November 11, 1988 illustration (J293) to make its point that

the Great West illustrations are flawed, although the plaintiff argues that it did not rely on this illustration to make its purchase decision, but rather based its decision on an illustration dated February 3, 1988 (J189) showing loans capped at $50,000. Nonetheless, neither the assumptions which Gary Lake prescribed in the RFP, nor those used by Great West in its November 11, 1988 illustration (J293), were unreasonable, according to the plaintiff's experts, Great West's actuaries, and even the defendant's witness, Dwight Bartlett. The government observes that Great West used a mortality table to price the policies that was different from the mortality assumption which Lake prescribed in the RFP, thus predicting a more optimistic performance than might have been justified (and, if Lake's assumption turned out to be correct, resulting in a loss to Great West). However, as Lake observed, he was not the insurance company's actuary nor was he responsible for its pricing, and the insurer's decision to price the policy based on a mortality table that it believed better reflected anticipated experience does not diminish the reasonableness of Dow's reliance on Lake's recommendation. The difference between the so-called "inside" and "outside" mortality assumptions proves no more than a professional disagreement on the actual mortality experience Dow more likely would realize, and does not justify the government's attempt to undermine the illustration through Ralph Sayre's *post hoc* "correction"; which uses mortality assumptions different than prescribed by Lake. The Court finds that Dow reasonably relied on Great West's prepurchase illustrations in making its decision to purchase the Great West policies. The illustrations showing a capped loan strategy demonstrated that Dow could expect to profit from the plan if it operated it on a basis other than a minimum payment strategy.

ii. Loan Strategy

Of course, this frames a principal factual dispute in this case: whether Dow intended to operate the plan on a minimum payment strategy, or, rather, whether it intended to cap loans at $50,000 and withdraw only to basis. There were multiple illustrations offered in evidence: those reflecting loans capped at $50,000 and those showing continued borrowing; those showing partial withdrawals to basis, and those showing taxable withdrawals above basis; age-specific illustrations and composite illustrations; pre-purchase illustrations, post-purchase illustrations and annual reillustrations. The government argues that the illustrations which Dow more likely relied upon in making its decision to purchase the Great West plan showed maximum borrowing, and that post-purchase illustrations and reillustrations all show uncapped loans. It also observes that Dow called only former employees to testify to Dow's intentions as to how it would operate the plans, instead of turning to current executives and employees of the insurance brokers who ran the illustrations. Leaving funds in the plans also exposed the investment to financial uncertainty, and the government contends that the timing of positive cash outflow did not match Dow's avowed financial need to offset anticipated retiree medical expenses. Finally, the government points to the tax protests filed by Dow as a condition of seeking a compromise, which, the government argues, contain admissions that Dow intended to operate the policies on the basis of a maximum borrowing strategy.

The Court finds that the witnesses whom Dow called at trial – former employees, for the most part – were the ones who most likely knew Dow's intentions concerning the Great West plan at the outset. Witnesses Falla, White, Jenkins and Burdett from Dow, and Gary Lake, the consultant, all testified that it was Dow's intention to cap

loans at $50,000 and withdraw only to basis. In fact, no one testified that Dow ever expressed an intention to borrow against the policies over the $50,000 limit. The government suggests that the failure by Dow to call others compels the Court to draw an adverse inference on this point. These witnesses, that is, Dow's current tax, treasury and human resources personnel, and representatives from Clark/Bardes, were equally available to the government, and, thus, under the circumstances no adverse inference is either required or warranted. *See Kilburn v. United States*, 938 F.2d 666, 675 (6th Cir. 1991). Moreover, the Court accepts the testimony of the plaintiff's witnesses as accurate and truthful, and concludes that Dow intended to cap loans at $50,000 and inject cash into the Great West plan in the middle years. This conclusion is buttressed by contemporaneous documentation which includes the original 1987 RFP (J127), Lake's analysis of the proposals (J146), Lake's final recommendation to White, and White's recommendation to Dow's COLI task force (J172, 174). Moreover, this strategy is more consistent with Dow's stated purpose of embarking on this project at the outset: the capped loan strategy produces higher positive cash flow to fund retiree medical costs. Further, it yielded more favorable financial performance in years after year 18 of the plan.

In addition, capping loans and limiting withdrawals was consistent with Dow's overall tax-avoidance strategy. Interest on loans above $50,000 per policy was not deductible in any event; withdrawing cash from the policies above basis would have exposed Dow to a tax on earnings which could have been avoided when those proceeds were paid out as death benefits. Further, as Dr. Myers pointed out, this plan did not financially "compel" borrowing by creating a great disparity between borrowed and unborrowed funds, as existed in the other COLI cases.

iii. Admissibility of Tax Protests

At trial, the defendant offered in evidence tax protests which Dow filed on three separate occasions prior to commencing the present action. Attached to the protests were illustrations which Dow used to demonstrate positive pre-tax cash flow as to its COLI plans, but the illustrations used did not show loans capped at $50,000. Dow timely objected to this evidence on the grounds that it was irrelevant and constituted evidence of settlement negotiations which is not admissible under Federal Rule of Evidence 408. The Court took evidence on a separate record from George Imwale, an IRS examiner, as to the purpose of protest procedure and conditionally received the evidence subject to resolution of the plaintiff's later-filed motion to strike the evidence.

Although Rule 408 does not bar evidence of tax protests as a matter of course, the Court finds that in the circumstances presented in this case, the evidence is barred by Rule 408, for reasons explained below. However, even if the evidence were received, the Court would ascribe very little weight to it, since it supports the claim that the COLI plans would generate substantial pre-tax economic benefit to Dow even if it pursued a maximum borrowing strategy, and the attachment of uncapped loan illustrations to the protests does not contradict the testimony of White, Falla, Burdett and Lake that Dow intended to operate the plans on a capped-loan basis at the outset. However, because there is very little decisional law on the issue, the Court will take a moment to deal with the question here.

The basis for the plaintiff's argument is that the filing of a protest is the first step in a process which leads to settlement discussions designed to resolve tax disputes with the government. The government states, however, that

protests are not filed with the Appeals Division but with the Examination Division; the process is not intended to be conciliatory, but rather adversarial.

At the conclusion of an audit by the IRS, the examiner prepares an examination report explaining the proposed adjustments. Treas. Reg. § 601.105(c)(2). In an "unagreed" (disputed) case, the IRS district director sends this report, known as the revenue agent's report ("RAR") to the taxpayer under cover of a "30-day letter." Treas. Reg. § 601.105(d)(1). The 30-day letter informs the taxpayer of its informal administrative appeal right, which is the right to an administrative appeal to the IRS's Appeals office, provided that a protest is filed. *Id.;* Treas. Reg. § 601.106(b). The regulations provide that, after review of any required written protest by the district director, the case and its administrative record are referred to the Appeals office. Tre as. Reg. § 601.106(b). The instructions for preparation of a written protest are included in the 30-day letter. Treas. Reg. § 601.105(d)(2)(v).

Upon receipt of the 30-day letter, the taxpayer has three options. First, the taxpayer can seek administrative settlement negotiations with IRS's Appeals office by filing a protest within 30 days or such an extended time as the IRS may permit. Second, the taxpayer can do nothing, which will trigger a statutory notice of deficiency, otherwise known as a "90-day letter." I.R.C. § 6212(a). A 90-day letter is also issued if negotiations with the Appeals office prove unsuccessful. Third, the taxpayer can pay the proposed liability and then seek a refund by filing an administrative claim for a refund with the IRS. The taxpayer may also follow this third course of action upon the failure of negotiations with the Appeals office or receipt of a 90-day letter. If an administrative claim for refund is denied or no action is taken on it for six months, then the taxpayer may

litigate its right to the claimed refund by filing a complaint in federal district court or in the United States Court of Federal Claims. I.R.C. §§ 6532, 7422(a); 28 U.S.C. § 1346.

The mission of the IRS Appeals Division is "to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service." Internal Revenue Manual (IRM) § 8.1.3.2(2) (May 19, 1998). This "mission is accomplished through a program of considering protested cases, holding conferences, and negotiating settlements." *Id.* § 8.1.3.2(1).

Instructions directed to the taxpayer in the 30-day letter state that any protest should be filed with the District Director and not the Appeals Division. Imwalle, Tr. 4649-50. Once received by the District Director, the protest is forwarded to the Examination Division Case Manager who in turn is required to take a number of actions with respect to the protest under applicable IRM procedures. *Id.* at 4650-64. The protest serves an important function for the Examination Division, which examines it to determine whether the IRS erred or if additional investigation needs to be done. *Id.* at 4661-62.

Dow alleges, and the government does not deny, that large corporate taxpayers like itself protest 80 to 90 percent of the taxes recommended on audit, and that as of 1997, the Appeals Division had resolved approximately 85 percent of its large cases. Dow M. to Strike Br. at 6 (citing GAO studies).

Federal Rule of Evidence 408 provides:

> Evidence of (1) furnishing or offering or promising to furnish, or (2) accepting or offering or promising to accept, a valuable consideration in compromising or attempting to compromise a claim which was disputed as to either validity or amount, is not admissible to prove liability for or invalidity of the claim or its amount. Evidence of conduct or statements made in compromise negotiations is likewise not admissible. This rule does not require the exclusion of any evidence otherwise discoverable merely because it is presented in the course of compromise negotiations. This rule also does not require exclusion when the evidence is offered for another purpose, such as proving bias or prejudice of a witness, negativing a contention of undue delay, or proving an effort to obstruct a criminal investigation or prosecution.

Rule 408 was intended to sweep broadly and "encompasses the whole of the settlement evidence." *Overseas Motors, Inc. v. Import Motors Ltd., Inc.*, 375 F. Supp. 499, 537 (E.D. Mich. 1974), *aff'd*, 519 F.2d 119 (6th Cir. 1975). The Rule's broad sweep was intended to abrogate the common-law requirement that protected statements always be posed hypothetically or specifically offered "without prejudice." *See* Advisory Notes to original Rule 408. When the applicability of Rule 408 is a close call, the court should lean toward exclusion. *Bradbury v. Phillips Petroleum Co.*, 815 F.2d 1356, 1364 (10th Cir. 1987).

However. "Rule 408 excludes only evidence of conduct and statements made solely as part of the settlement negotiations, and not statements and conduct made at . . .

meeting[s] which are unrelated to such compromise negotiations." *Trans Union Credit Info. Co. v. Assoc. Credit Servs.*, 805 F.2d 188, 192 (6th Cir. 1986). Thus, the Court must find that the party seeking exclusion subjectively intended the statements to be part of negotiations toward compromise. *See Blu-J, Inc. v. Kemper C.P.A. Group*, 916 F.2d 637, 641-42 (11th Cir. 1990). Rule 408 also does not apply if the claim at issue is not in dispute. An actual lawsuit need not have been filed, but there must be "at least an apparent difference of view between the parties[] concerning the validity or amount of the claim." Weinstein's Federal Evidence § 408.06, at 408-23 (rev. 1998).

Although it is tempting to define the existence of negotiations by an objective standard, courts generally agree that the proper inquiry is whether the person making the statement *believed* that the statement was related to negotiations. *See, e.g., Affiliated Mfrs., Inc. v. Aluminum Co. of Amer.*, 56 F.3d 521, 528-30 (3d Cir. 1995) (affirming exclusion of both a letter between the parties and the defendant's internal memoranda regarding the possibility of settlement). *See also Ramada Dev. Co. v. Rauch*, 644 F.2d 1097, 1106-07 (5th Cir. Unit B 1981) (affirming exclusion of architectural report commissioned by the opposing party to ensure an informed settlement position). The belief, however, must be both honest and reasonable; where a statement is made to induce reliance or made in bad faith, the Rule will not prohibit its introduction in evidence. *Cf. Uforma/Shelby Bus. Forms, Inc. v. NLRB*, 111 F.3d 1284, 1293-94 (6th Cir. 1997) (holding that Rule 408 does not protect wrongs committed during the negotiations that are unrelated to the subject of the compromise).

The plain language of Rule 408 allows statements made in settlement negotiations to be introduced for purposes other than proof of liability or amount of damages.

See Fed. R. Evid. 408 ("This rule also does not require exclusion when the evidence is offered for another purpose, such as proving bias or prejudice of a witness, negativing a contention of undue delay, or proving an effort to obstruct a criminal investigation or prosecution."). Accordingly, the defendant argues here that statements otherwise protected under Rule 408 can be used for garden-variety impeachment, citing *Bankcard Am., Inc. v. Univ. Bancard Sys.*, 203 F.3d 477, 484 (7th Cir. 2000), *cert. denied*, 531 U.S. 877 (2000). However, that case does not support the broad proposition for which it is cited. *Bankcard* involved a RICO claim between two sales organizations. The court found that Rule 408 was not intended to permit a party to induce detrimental reliance on a promise made during negotiations and then assert confidentiality when the victimized party claimed estoppel. *Id.* at 484. See *also Starter Corp. v. Converse, Inc.*, 170 F.3d 286, 293-94 (2d Cir. 1999) (same). The application of an estoppel exception to Rule 408 is quite consistent with its goal of encouraging settlement, as it is difficult to understand how protecting fraud and deception will in any way advance parties' confidence in the settlement process. *Ibid.* There is little difference, however, between use of a statement made for settlement purposes to impeach the denial of liability, and offering it as an admission of liability. Asserting that a statement is offered as impeachment will not alone establish an exception to Rule 408. The appropriate approach has been established by the Second Circuit: the Court must weigh the competing policy rationales of encouraging settlement versus the formation of a complete record to determine whether the impeaching evidence falls within Rule 408's exception. *Starter*, 170 F.3d at 293; *see also* Weinstein's Federal Evidence § 408.08[1], at 408-30 (rev. 2002).

In this case, this issue turns on the subjective intent of Dow when it filed its protests. Dow insists that it did so only

to pursue the appeals process; the government counters that protests go to the Examination Division, not Appeals, and that Dow never intended the protests to be only for settlement purposes.

Dow relies on its assertions that (1) it filed the protest solely for settlement purposes; (2) a protest is not required to litigate a refund, and that there is no other reason to file a protest if not to pursue negotiation; (3) large corporations usually protest 80% or more of their audits, and approximately 85% of those cases are settled; and (4) the initial 30-day letter from the government for the 1989-91 audit cycle suggests that if Dow would like a conference with the Regional Office of Appeals, it should file a protest within 30 days.

The government responds that (1) Dow's belief, if true, is unreasonable, as it should know that protests are in fact filed with Examination, not Appeals; (2) Dow signed the statements in the protest under oath, suggesting that they were not subject to factual compromise; (3) Dow's protests never mentioned an intention to settle, even on the last protest filed three months before this case was initiated; (4) the Examination division had no power to settle Dow's case; (5) Rule 408 applies only to offers of compromise that function as an admission of weakness; (6) when Dow did want to protect documents from disclosure – such as when it negotiated with Appeals in August, 2000 – it clearly indicated that the documents were "For Settlement Purposes Only."

The Court is persuaded that Dow reasonably believed that the only avenue to the Appeals Division, and thus an opportunity to compromise and settlement the dispute, was by first filing a protest. Given the undisputed fact that the vast majority of disallowances on large taxpayer returns are

protested, and the great majority of those protests settled, it is reasonable to conclude that Dow filed its protests believing that it was embarking on the settlement path, leading to the Appeals Division whose mission is "to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service." IRM § 8.1.3.2(2) (May 19, 1998). The statements, therefore, fall within the protection of Rule 408, and are not admissible to prove liability or damages.

iv. Time Periods

It is undisputed that the capped loan illustrations, showing positive cash flow even without the income tax deductions, demonstrate negative pre-tax cash flow in the first eighteen years. The Court, however, does not confine its analysis of the transaction to isolated blocks of time, but rather evaluates the transaction as a whole. *CM Holdings,* 254 B.R. at 598 (citing *ACM Partnership,* 157 F.3d at 246). In *CM Holdings,* the court looked to the entire 81-year plan, observing that pre-tax cash flow did "not turn positive until the 53rd year of the plan." *Id.* at 629. In *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), the Supreme Court upheld a sale-and-lease-back transaction against a sham challenge after examining the transaction over its entire 25 years and beyond. Here, Dow did not necessarily expect an immediate return, but focused primarily on a source of funding to offset future retiree medical expenses. Positive pre-tax cash flows delayed for eighteen years is consistent with this subjective business purpose, and does not render the transaction economically empty.

v. Net Present Value

However, "[i]n transactions that are designed to yield deferred rather than immediate returns, present value adjustments are, as the courts have recognized, an appropriate means of assessing the transaction's actual and anticipated economic effects." *ACM Partnership*, 157 F.3d at 259. The process of adjusting for net present value (NPV) consists of discounting future earnings by a factor which is intended to reflect the time-value of money. Myers, Tr. at 3306-08; Plotkin, Tr. at 4024. The choice of an appropriate discount factor depends on the purpose of the inquiry. Here, the government points to the November 11, 1988 Great West illustration, as adjusted by Sayre, and demonstrates that plan produces a positive net present value cash flow absent tax deductions at discount factors below 4.69% and negative cash flow at discount factors above that rate. The government contends that the appropriate discount rate to apply was upwards of 9% as reflected by Moody's corporate average of investments, which also happened to be the rate used to determine the policy variable credited rate.

The Court is not persuaded that this analysis provides a reliable basis to determine the economic substance of an insurance plan. As explained by Dr. Myers and Dr. Plotkin, NPV analyses are useful in comparing investments and in evaluating a corporation's investment against its cost of capital. However, since the cash invested in an insurance policy builds up tax free (if it is paid out as a death benefit), Moody's corporate average does not furnish an equivalent basis for comparison. According to Dr. Myers, the tax-free inside build-up feature of life insurance justifies a lower discount factor. He calculated a NPV of $76 million at the inception of the Great West plan in May 1988. This demonstrates a substantial, non-tax benefit enjoyed by Dow.

vi. Inside Build-up

In its alternative argument, the government adopts the approach it took in the previous COLI cases and attempts to isolate the potential economic benefits which come from cash value life insurance consisting of death benefit proceeds and return as inside build-up. As to the latter element, the government's argument hinges on the premise that Dow intended to operate the Great West plan on a minimum payment strategy and thereby strip all excess cash from the policies. Had it done so, Dow likely would not have realized any substantial gain from the inside build-up. This infirmity existed in the previous COLI cases. *See, e.g., AEP*, 136 F. Supp. 2d at 787-88 ("[T]he plan contemplated that literally every penny of inside buildup would be used to support policy loans."). This Court has already determined, however, that Dow did not intend to operate its policies in that fashion. Over the life of the plan, Dow stood to realize substantial economic gain from tax-free inside build-up returned in the form of death benefits.

vii. Mortality Features

The government's argument that Dow could not expect to profit from death benefit payments is based on the contention that the Great West plan was "mortality neutral," a term which the government has invented to mean that the cost of insurance paid will equal the death benefits awarded upon the deaths of all of the insured lives.[6] The government contends that "mortality neutrality" renders this aspect of a life insurance plan a sham. On its surface, the Court finds this argument somewhat curious and quite provocative, since

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6 The experts questioned on the subject agreed that "mortality neutrality" is not a term or concept recognized by actuarial science. Hickman, Tr. at 2934-35; Plotkin, Tr. at 4057; Bartlett, Tr. at 4784-85.

it potentially could invalidate all forms of group life insurance. Virtually all insurance policies are designed prospectively so that the cost of insurance equates with the death benefit paid. In fact, the cost of insurance will generally be more than the death benefit because the insurance company needs to make a profit. That is the objective of actuarial calculations of mortality statistics in pricing. Consequently, all insurance policies are "designed" to be "mortality neutral," if not "mortality negative" (from the standpoint of the insured), on a prospective basis. What the insured purchases is protection against the risk of *premature* death. Therefore, the validity of life insurance, at least from a tax standpoint, is determined by whether there is genuine risk-shifting. *See Helvering v. LeGierse,* 312 U.S. 531, 539-542(1941) (recognizing that "insurance involves risk-shifting and risk distributing"). The risk component of the COI is the cost of assuming the risk, at the beginning of the policy period, that the actual death rates of insureds in a certain block of business will vary from the expected death rates predicted by the actuary.

In the three prior cases, courts found that the COLI plans were flawed because of devices designed into the plans that eliminated the transfer of risk. Those courts thus adopted the government's terminology and found that the plans were "mortality neutral" when, after the relevant period, usually a year, the cost of insurance (COI) and death benefits were "trued up" retrospectively. That is, when there is an agreement contained in the plan to make payments after the conclusion of a policy year so that the COI equals the amount paid out in death benefits, risk is eliminated and, as insurance, the COLI transaction is economically meaningless. *See Winn-Dixie,* 113 T.C. at 268-69, 285; *CM Holdings,* 254 B.R. at 632-35; *AEP,* 136 F. Supp. 2d at 777, 787-88.

As noted earlier, the Great West plan did not contain a 100% retrospective payment mechanism. In arguing otherwise, the government refers to the RFP in which Dow prescribed that its plan be fully experience-rated, Great West's conservative pricing, and the contractual right of Great West to increase the spread on the X-Rider to account for prior years' unfavorable mortality experience. There was also a dividend feature built into the policies that required Great West to "share" favorable mortality experience with the policyholders. The dividend payment was a form of retrospective adjustment, but it was not, nor could it have been, a 100% "true-up," since Dow's Great West policies were part of a pool which shared mortality experience. All of the other mechanisms constituted prospective adjustments, and, although they were designed to fine tune the risk allocation going forward, they did not eliminate past risk transfer as did the plans in *AEP* and *CM Holdings*.

It is not inconceivable that mortality pricing could, in some cases, be so conservative that practical risk transfer does not exist. In this case, however, Great West's mortality pricing was based on a standardized mortality table, and there is no evidence that its pricing was commercially unreasonable. The Great West insurance policies were not "mortality neutral" as that term is used in the prior COLI cases.

The plaintiff has demonstrated, by a preponderance of the evidence, that its COLI plan with Great West caused practical economic effects apart from the income tax deductions that were consistent with Dow's stated purpose for entering into the transaction. This plan was not an economic sham.

b. MetLife COLI Plan

The government similarly contends that the MetLife plan is bereft of economic substance, based on prepurchase illustrations which show negative cash flow without the tax deductions for policy loan interest on both an absolute and net present value basis. The government also reasserts its contention that the MetLife COLI plan is "mortality neutral" so that Dow could not profit from the payment of death benefits, and that Dow intended to strip all excess cash from this plan as well.

i. Illustrations

As with the Great West plan, there were prepurchase illustrations describing the MetLife COLI plan which showed positive pre-tax cash flow, although not in the first seventeen years of the policy when it is undisputed that the acquisition strategy called for maximum borrowing and partial withdrawals. As noted above, after Michigan law changed in the beginning of 1991 concerning an employer's insurable interest in lower level employees, Dow reactivated its COLI task force. Clark/Bardes furnished several proposals and sales illustrations throughout the spring of that year, although in June it became apparent that Dow would likely enter alternative minimum taxpayer (AMT) status. Dow's treasurer, Howard Burdett, testified, however, that the loss of tax deductions that would accompany AMT status, at least in the near term, was not enough "to offset the benefits that COLI would bring to Dow long term." Tr. at 1415. Dow was thus examining the prospect of generating cash through the COLI plan after the acquisition phase of the policy and viewed the performance of the plan over its whole life.

Presentations were made to Dow by several insurance companies at an August 1991 meeting in Washington, D.C., and in September Clark/Bardes furnished illustrations of the MetLife plan showing both capped and uncapped loans, which has come to be known as "Scenario 1" and "Scenario 2." In early October 1991, Dow received additional illustrations showing positive cash flows. These were identified at trial as "Case 23" and "Case 24," the difference between the two being the uncapped (Case 24) and capped (Case 23) loan strategies that were illustrated. These were single-employee, age-specific illustrations and demonstrated positive cash flow absent the income tax deductions for policy loan interest over the life of the plan, as noted above. Case 23 called for a borrowed credited rate of 8.68% in the first eight years, increasing to 9.2% thereafter; the loan rate was 9.45%, which closely approximated Moody's Corporate Average. The unborrowed credited rate was 5.5% in the first seventeen years, increasing to 8.75% thereafter when, according to the illustration, partial withdrawals ceased and cash would have to be paid in to cover loan interest charges. The age-specific illustration shows cash flow net of tax deductions totaling $213,262 on a single life (age 40) over the 60-year life of the policy. The final census on the MetLife policy after the union employees were added was 17,061 individuals, which yields a positive pre-tax return in the whole plan of over $3.6 billion.

The government acknowledges these facts, but argues that Dow did not actually intend to operate the policy in this fashion, and further observes that the pre-tax cash flow is negative on a NPV basis at certain discount rates.

ii. Loan Strategy

As noted above, the plaintiff's witnesses testified that borrowing strategy for the MetLife policy was the same as

for the Great West policies: to cap loans at $50,000, and, given the Court's findings with respect to the Great West policies, the Court has little trouble concluding that Dow's initial plan was to operate the MetLife policy as the Case 23 illustration demonstrates. John Ryan from MetLife corroborated the intention to pursue this strategy, as described by Falla, White and Burdett of Dow. The higher unborrowed credited rate beginning in year eighteen, which was negotiated by Dow, is consistent with this operational strategy. The Memorandum of Understanding (MOU) limited Dow's right to withdraw cash in the later years, but this limitation would not necessarily discourage investment in the policies. Rather, it simply required a cash management plan looking forward four years. And the observations on the adverse tax consequences of borrowing above the $50,000 limit and withdrawing above basis made as to the Great West policies apply with equal force here.

iii. Net Present Value

The government called Dr. James Hoag, an economist, to testify to his calculations of the NPV of the MetLife policy. He used an early composite illustration and applied Moody's Corporate Average as a discount factor, and concluded that the pre-tax NPV of the plan was negative. Hoag then analyzed Case 24 and concluded that the MetLife program would not generate a positive NPV at any discount rate. The plaintiff's experts, Dr. Myers and Dr. Plotkin, explained that this analysis failed to take into consideration the tax-free nature of the inside build-up in cash-value insurance policies, as noted above. Using Case 23, Myers estimated that the NPV of the "investment leg" of the MetLife plan was approximately $370 million at inception, and the NPV of the "borrowing leg," which included the value of the tax deductions, was $15.1 million. Myers, Tr. at 3328-30, 3333-34. Myers did not use Moody's corporate

average as a discount rate, because he concluded that it was not reasonable to compare this insurance plan to general corporate investments subject to income taxation. Moreover, even using the defendant's method of discounting, the MetLife policy, as illustrated by Case 23, yields a positive NPV absent policy loan income tax deductions at discount rates below 7%. Hoag, Tr. at 6391-92. Once again, this analysis demonstrates a substantial non-tax benefit to Dow over the life of the plan.

iv. Inside Build-up

In the MetLife plan, Case 23 belies the government's contention that there was an intention to strip the policy of its cash value through continued borrowing and partial withdrawals above basis. In fact, Dow witnesses acknowledged that cash would have to be injected into the plan after the seventeenth year. The higher unborrowed credited rate provides a substantial return, especially considering that the inside build-up occurs tax free. When applying the two-part analysis from the other COLI cases which focus on the financial benefits of cash value life insurance, the Court concludes that there is no failure of proof that Dow would enjoy a financial advantage from the cash value accruing on the MetLife policy.

v. Mortality Features

The method of calculating the COI in the MetLife policy is derived from the terms of the policy itself when read together with the MOU. The government argues that the policy was designed to be "mortality neutral, if not virtually mortality riskless," Def. Post-trial Br. at 22, because the plan was experience-rated, MetLife refunded mortality dividends on an annual basis, and MetLife reserved the right to increase COI charges to recoup losses if claims for death

benefits exceeded COI charges. As indicators of an economic sham, these arguments fall wide of the mark. None of these features by themselves or in combination constitute a 100% true-up mechanism, that is, a "full paid loss retro."

The MetLife policy was experience-rated *prospectively*, in the sense that the mortality statistics used to calculate the COI were derived from Dow's actual experience that Gary Lake complied. The dividend feature, common among group life insurance contracts according to the plaintiff's experts, *see, e.g.*, Plotkin, Tr. at 4038, 4047, was a benefit to Dow, but it did not transfer risk away from MetLife. MetLife's contractual right to adjust the COI going forward to recoup losses caused by benefit payments that exceeded COI was limited by the stop-loss provision. Once again, the witnesses generally agreed that stop-loss provisions are standard experience-rating mechanisms common in group life insurance administration. Yau, Tr. at 1987; Rogalski, Tr. at 2456; Plotkin, Tr. at 4050; Bartlett, Tr. at 4925.

The government contends that the MetLife policy was conservatively priced. However, the parties' experts agreed that Charles Yau's decision to use Dow's actual mortality experience in setting the COI rates was reasonable and actuarially sound. *See* Rogalski, Tr. at 2454; Hickman, Tr. at 2961, 2968; DesRochers, Tr. at 3648-49; Bartlett, Tr. 4761; Sayre, Tr. at 6048. Yau developed a mortality schedule based on this data and converted it into the COI rates reflected in Attachment 2 of the MOU. Yau, Tr. at 2012-13. He did not add any additional margin. Nor was the price for the stop loss, 2.2%, an unreasonable charge that eliminated the transfer of risk. Yau actually calculated the appropriate charge to be 2.71%, with .71% representing the cost of assuming the risk that annual deaths would exceed

the 115% stop-loss limitation (calculated at a 10% probability), and 2% representing profit and return on capital. Through negotiations, the parties agreed on the 2.2% figure. After receiving a revised census with specific age cells approximately one month after the agreement was executed, Yau recalculated the risk exposure and discovered that there was actually an 18% probability that death benefits would exceed 115%, and therefore the stop-loss was underpriced. Further, this figure did not account for catastrophic loss, for which MetLife actually purchased reinsurance.

The defendant's expert, Dwight Bartlett, opined that the stop loss was actually greater than 115% and therefore the likelihood of Dow profiting from mortality, that is, receiving benefits in excess of COI, was extremely remote. Bartlett reached this conclusion, however, by adding the 2.2% retention charge to the stop-loss amount, thereby recalculating the stop-loss at 117.2%, which contradicted the express terms of the MOU, *see* J408, and effectively eliminated MetLife's profit because the 2.2% would not be available for its intended purpose. Bartlett also contended that Yau should have adjusted the COI charges to account for an improving mortality trend among the general population over time. Howeve r, Yau used Dow's actual mortality statistics; he characterized the data as the best mortality information he ever had in pricing a case. Yau, Tr. at 2365.

As noted earlier, the Court concludes that the mortality features of the MetLife plan constituted the actual transfer of risk, were reasonably priced, and did not contain a 100% retrospective adjustment mechanism that rendered the transaction a sham.

c. Conclusion

The Court finds that Dow has established by a preponderance of the evidence that both its Great West and MetLife COLI plans were imbued with economic substance. The plans had substantial effects on the beneficial interest of the taxpayer apart from the income tax deductions. Although, from a subjective standpoint, tax deductions were discussed and considered by Dow's COLI task forces, focus on the tax deductions themselves did not predominate. In this respect, this case differs markedly from the prior COLI cases in which "the marketing information presented to [the other taxpayers'] executives showed that, absent tax deductions, the plan would lose money[, but they] agreed to the plan knowing the tax deductions were the only thing that made it worthwhile." *In re CM Holdings*, 301 F.3d at 103. Dow's COLI plans are not economic shams.

2. Shams in Fact

In deciding whether a transaction is a sham in fact, the Court examines the nature and form of the transaction to determine what actually occurred. In making this assessment, the Court "will ignore accounting tricks and other transactional artifices." *CM Holdings*, 254 B.R. at 600 (quoting *Peerless Indus., Inc. v. United States*, 19 94 WL 13837 at *4 (E.D. Pa.), *aff'd*, 37 F.3d 1488 (3rd Cir. 1994)). The Court considers whether appropriate business formalities are employed, industry customs and practices are followed, and there is compliance with relevant commercial norms. Thus, paper transactions which solely attempt to create deductible losses or expenses are not recognized. *Woolford Realty v. Rose*, 286 U.S. 319, 330 (1932) (stating that "[t]he mind rebels against the notion that Congress . . . [was] willing to foster an opportunity for juggling so facile and so obvious"). But transactions involving two or more

parties which are grounded in commercial custom and have present or future economic consequence to one or more parties will be recognized. *See CM Holdings*, 254 B.R. at 600 and cases cited therein.

a. Policy Loans

In this case, the government revives the argument presented without success in the three previous COLI cases that the policy loans in both of Dow's plans are factual shams because they were "simultaneous netting transactions" which were "sourced" from the very premiums paid by the proceeds. The government characterizes the loans as "cashless" and "circular," existing only "on paper" for the purpose of generating the tax deductions that fueled COLI plans. The policy loans in this case took the form of the loans in the previous cases: in the first three years of each of the plans, Dow would receive a bill from the insurance company that netted the premium and interest charges against the proceeds of a loan that was made on the first day of the policy year, leaving a relatively small balance to pay in cash. The premium payment created value in the policy, which was used as security for repayment of the loan. In the MetLife plan, for example, the gross annual premium for the first year was $170,510,000, the policy loan that year was $158,756,000, leaving a cash payment from Dow to MetLife of $11,754,000, or approximately 0.68% of the gross annual premium. The government contends that as further evidence of the sham character of this transaction, the interest rate (indexed to Moody's Corporate Average) was excessive and set in a collusive manner, and the loans were "backdated."

These arguments have been rejected by courts previously, and the same result obtains here. Policy loans are not made from the cash contained in the insurance policy. Rather, "[i]t is the longstanding custom and practice in the

insurance industry that policy loans are deemed as made from the general funds of the insurance company, with the policy value serving only as collateral." *AEP*, 136 F. Supp. 2d at 780; *see also* Stip., ¶24; McGill, Tr. at 5093-94. Consequently, the fact that there is no value on the first day of the policy until the premium is paid does not affect the validity of the insurance company's act of advancing sums from its general funds to pay the premium, or in taking as collateral the policy value that results from the payment of that premium. The loan created actual indebtedness on the books of Dow (and a corresponding asset for the respective insurers), which was repaid from death benefit proceeds as the insureds died: the death benefit was reduced by the amount of the loan and unpaid interest. The use of a netting transaction in this instance did not make the loans a sham. The IRS itself regularly utilizes netting transactions when allowing taxpayers to apply refunds from prior years to the payment of current tax obligations as shown on tax returns. The use of the device with loans is no different, or any less valid. As the Third Circuit noted, "[a] circular netting transaction, where different loans and payments are deemed to occur simultaneously (and thereby offset each other), is not by definition a factual sham. As the District Court pointed out, the simultaneous netting of the payment and the loan with the policy value as collateral that occurred in years 1-3 is common in the industry, and is a transaction with economic substance." *In re CM Holdings*, 301 F.3d at 108.

The interest rate on policy loans in both plans was variable, indexed to Moody's Corporate Average (a composite average of the full range of investment grade debt instrument interest rates), and subject to a fixed spread between that rate and the credited rate on the cash value in the policies. In the prior COLI cases, the policyholders were given a choice of loan rates and universally chose the highest, which was referred to as "Moody's Baa Enhanced"

rate, indexed to the lowest-rated corporate bonds, rated BAA. Although a higher interest rate would normally be adverse to the borrower's interest, it had no practical effect in those cases because of the fixed spread, and served as evidence of a collusive arrangement to drive up interest rates for the sole purpose of increasing the tax deductions for interest payments. In *CM Holdings*, the government's experts testified that indexing the loans to Moody's rating of the riskiest corporate grade debt instruments was not reasonable. Two of the government's experts in this case also testified in *CM Holdings*; when asked here what would have been an acceptable variable loan interest rate for COLI policies, "Bartlett and McGill testified an appropriate interest rate for Camelot's policy loans would be Moody's Corporate Average." *CM Holdings*, 254 B.R. at 605. Other government experts in this case testified that the appropriate rate would be the short-term bond index. Puglisi, Tr. at 5230-32, 5239-41; Hoag, Tr. at 6200-01.

The Court finds that the policy loan rates were reasonable and commercially acceptable. Moody's Corporate Average is the rate referenced in the NAIC Model Policy Loan Interest Rate Bill, the relevant Michigan statute (Mich. Comp. Laws § 500.4023), the proposed Pryor/Kennelly legislation (H.R. 4389, 101st Cong., 2d Sess. § 1(a) (1990); S. 2722, 101st Cong., 2d Sess. § 1(a) (1990)), and the Health Insurance Portability and Accountability Act of 1996 (now codified at IRC § 264(e)). J1256; J1270; DesRochers, Tr. at 3596; Puglisi, Tr. at 5255-56, 5258, 5260. The variable loan interest rate under the Great West and MetLife policies did not exceed the maximum variable policy loan interest rate provided by the NAIC Model Policy Loan Interest Rate Bill or Michigan Compiled Laws § 500.4023. The MetLife policy allowed the policyholder on a policy anniversary date to elect for future policy years a fixed loan interest rate of 8% in lieu of the variable rate based on Moody's Corporate

Average. The Great West policies provided for no such election. Stip., ¶ 121; J408, J409. Dow did not elect the fixed 8% interest rate under either MetLife policy at any time. The variable rate that it paid turned out to be above that rate in policy years one, two, and four, but below that rate in policy years three, five, six, and seven. Stip., at ¶ 123; Hoag, Tr. at. 6472. Moody's Corporate Average as a borrowing rate for policy loans is a traditional and regulatory favored variable interest rate. The reason for this is that this interest rate is similar to that which the insurance company might otherwise expect to garner from other investments, and therefore the use of this rate decreases the sensitivity of the insurance company's financial statements to policyholder borrowing. Plotkin, Tr. at 4085-86; DesRochers, Tr. at 3596-97, 3598; Bartlett, Tr. at 5022-23; Sayre, Tr. at 5824, 5926; Todd, Tr. at 607, 636-37; Laeyendecker, Tr. at 1154. A variable loan interest rate equal to Moody's Corporate Average is commonly used for policy loans in the life insurance industry. Plotkin, Tr. at 4085-86; Bartlett, Tr. at 5022-23; Puglisi, Tr. at 5290; Sayre, Tr. at 5905-06.

The plaintiff has established by a preponderance of the evidence that the policy loans were real transactions consistent with commercial norms, and therefore were not factual shams.

b. Partial Withdrawals

The government also contends that the partial withdrawals in years four through seven of the Great West policies and the MetLife policy, used to pay policy premiums, were shams in fact. It compares the partial withdrawals to the loading dividends that the district courts found to be factual shams in *CM Holdings* and *AEP* because of the circular and unconventional nature of the structure of those payments. The Third Circuit disagreed with the

district court's holding in *CM Holdings* and concluded in *dicta* that "[t]he loading dividends of years 4-7 were [] simultaneous netting transactions that 'actually occurred,' and are therefore not factual shams." 301 F.3d at 108. Moreover, the courts in both *CM Holdings* and *AEP* found that the partial withdrawals in those cases were real. *CM Holdings*, 254 B.R. at 618-19; *AEP*, 136 F. Supp. 2d at 785 ("The government initially claimed that these partial withdrawals were factual shams but did not include that claim in its post-trial brief. Be that as it may, the court concludes that these withdrawals were real.") This Court finds that the comparison of the partial withdrawals in this case with the loading dividends in the prior cases is inapt, but also finds an important and material difference in the features of the partial withdrawals of the Great West and MetLife policies which distinguishes them from their counterparts in the policies in *CM Holdings* and *AEP*, and compels the conclusion that they are factual shams.

A partial withdrawal is a means of accessing the cash value in a life insurance policy. The right to make a partial withdrawal, however, is entirely dependent on the terms of the insurance contract. In *CM Holdings*, the policy placed no limit on the amount of the policy value that could be taken; however, in years four through seven there was no net equity at the beginning of the policy year because all of the cash value was encumbered as security for loans. 254 B.R. at 618. This did not present an obstacle to the transaction because although the partial withdrawal lowered the policy value and the corresponding loan limit, the proceeds from the partial withdrawal were not used to pay premiums, but rather were applied to the loan balance by paying accrued interest. *Ibid.* It also reduced the death benefit. The source of the partial withdrawal was existing policy value, albeit encumbered value, which could be accessed according to the terms of the insurance contract.

In this case, on the last day of each of policy years four through seven, the cash value of Dow's Great West and MetLife policies was fully encumbered, yielding virtually zero net equity. Nevertheless, in the fourth through seventh years of the Great West plan and the fourth and fifth years of the MetLife plan, Dow made partial withdrawals that exceeded the premiums due in those years. DesRochers, Tr. at 3728-29; Ex. D777. The partial withdrawals were accomplished through a circular series of interdependent transactions in which (1) the gross premium was deemed paid; (2) the deemed payment of the premium created cash value; (3) Dow made a partial withdrawal of the cash value; and (4) the partial withdrawal was used to offset approximately 90% of the premium and accrued loan interest. DesRochers, Tr. at 3730-32; McGill, Tr. at 5154-55; Sayre, at Tr. 5613-16. The partial withdrawal transactions under the MetLife program were carried out through simultaneous netting transactions. DesRochers, Tr. at 3732. Great West and Dow introduced a one-day time lag into the partial withdrawal transactions under the Great West plan, whereby transactions occurred on separate days but Dow did not lose any interest as a result of being out of funds overnight. Todd, Tr. at 848-49; Burdett, Tr. at 1622-25; McGill, Tr. at 5155-56; Ex. J448. Sending funds to Dow via wire transfer so that the funds were received on the same day Dow's previously-mailed check cleared neutralized the effect on Dow's bank account at the end of the day, justifying the characterization of the transaction as "simultaneous" for the purpose of this inquiry.

The problem with these transactions does not stem from the practice of netting the withdrawals against the premium obligation. Rather, the transaction was a sham because there was no value in the policy that could be withdrawn to pay the premium, according to the limitations in the respective insurance contracts. Unlike the policy

loans, which were made from the insurance company's general funds, the source of the partial withdrawals must be the accessible cash value in the policies themselves. The Great West policies included a Partial Withdrawal Provision Amendment, which stated:

> By written request, the Owner may make partial withdrawals from the cash value of the Additional Paid-Up Life Insurance Benefit Rider, herein called the "Rider." *Partial withdrawals will be limited by the amount of any outstanding loans and loan interest due at the end of the Rider year.*

Ex. J1147, at CBTX 020204 (emphasis added). Similarly, the MetLife policy contains a partial withdrawal provision which limits the availability of funds in the policy:

> The Employer may request a partial Cash Withdrawal of at least *$10,000.* The available Cash Surrender Value will be determined as of the date Metropolitan receives the request. . . . The maximum amount available for a partial Cash Withdrawal is the smaller of the Cash Surrender Value less the future Monthly Deductions up to the next Policy Anniversary Date or the Cash Surrender Value minus *$1000.*

Ex. J593, at A014130-31. "Cash Surrender Value" is defined as "the Cash Value, *less any Loan and Loan Interest.* It is also the sum of the Account Values applicable to all insured Employees." *Id.* at A014122 (emphasis added). Thus, in both plans, the insurance contracts limited the funds available for partial withdrawal to *unencumbered* cash value.

Since the unencumbered cash value in the policies at the beginning of the fourth through seventh years was zero, there was nothing available to withdraw or to offset against the premium obligation. There was no basis upon which the premiums for that year could be "deemed" paid, except for the 10% that did not look to the partial withdrawal as the source of payment. The "payment" of 90% of the premium was not real, since it essentially came from nothing. That portion of the transaction in each plan, therefore, was a sham in fact.

c. Backdating

Because the insurance policies under both of the plans were delivered and the final censuses determined after the agreed effective dates of the respective policies, the government contends that calculating interest on the first-year policy loans from the effective dates of the policies, rather than the final issue dates, constituted backdating the loans. The government argues that the interest paid (and deducted) for that interim period constituted phantom interest, since there was no debt obligation that required an interest payment. As noted earlier, the government made a similar argument in *AEP*, where the company entered into a prepayment agreement with the insurer that provided for temporary coverage from the application date to the date the policy was issued. However, there was an explicit provision in the prepayment agreement freeing AEP of the obligation to pay loan interest, and the insurer from crediting interest to policy values, until the policies were actually issued. *See AEP*, 136 F. Supp. 2d at 781. When the policies were issued, they were backdated to the application date, as were the loans. The court found, however, that the insurer had not advanced any funds during the interim period, nor was there any insurance policy in existence that could have served as loan collateral. *Ibid.* Finally, the policies were transferred to

a grantor trust which did not even exist during the interim period, but thereby became liable for an interest obligation that preceded its existence. *Id.* at 782. The court found the loans and interest obligation during the interim period to be factual shams. *Ibid.*

Dow argues that the circumstances in this case differ from those in *AEP* because of the express agreement between Dow and the two respective insurers to begin coverage under the policies as of the application dates, despite the need to refine the employee census and engage in other underwriting tasks thereafter. Since coverage began on the application date, so did the obligation to pay a premium, which all along was intended to be financed in the first year by a maximum policy loan; consequently, the argument goes, there is no phantom interest since there was a real debt obligation during the period between the application date and the date of final issue.

Michigan law does not prohibit an insurer from agreeing to make life insurance coverage effective at any time, as long as the period does not precede the *application date* by six months. *See* Mich. Comp. Laws § 500.4046 ("No policy of life insurance other than industrial life insurance shall be issued or delivered in this state if it contain[s] . . . [a] provision by which the policy shall purport to be issued or to take effect as of a date more than 6 months before the application therefor was made, if thereby the premium on such policy or contract is reduced below the premium which would be payable thereon as determined by the nearest birthday of the insured at the time when such application was made."). The Court of Appeals for the Sixth Circuit, applying Michigan law, has held that an agreement between an insurer and insured which provides that life insurance coverage is effective on the application date is one that the courts must honor, and it fixes the obligation as to

when premiums are due. *New York Life Ins. Co. v. McConchie*, 264 F.2d 17, 19-20 (6th Cir. 1959) (reversing lower court's reformation of policy to reflect as effective date the delivery date of the policy). "The parties had the right, even in the absence of a provision in the application, to agree on the effective date of the policy." *Id.* at 19. The plaintiff's witnesses testified in this case without substantial contradiction that it is customary in the life insurance industry to make a policy effective on the application date if the policy is ultimately issued, and to charge a premium from the effective date. Lake, (1/16 a.m.) Tr. at 546-47; Todd, Tr. at 740-42; Ryan, Tr. at 1915; Dykhouse, Tr. at 2766-67.

In this case, after Dow had chosen Great West as the insurer for its 1988 COLI plan, it sent Great West a census tape with pertinent information on 4,359 eligible insureds. Ex. J215; Todd, Tr. at 726-27. This occurred on April 20, 1988. In May, Dow and Great West entered into an agreement, entitled "Application for Insurance," which provided Dow, under certain conditions, temporary insurance covering approximately 4,000 employees while individual policies for these employees were processed. However, the agreement provided that once processed, the policies would be effective from the "Common Due Date." Ex. J231 ("It is understood by the parties that each qualified employee will make an individual application for a life insurance policy ('Policy') for which Dow . . . will be the beneficiary and have all rights of ownership. . . . All Policies will be issued with the same policy date, which will be the Common Due Date . . . ."). The Application defined the Common Due Date as "the date this application is signed by both parties." Dow executed the Application on May 9, 1988, Great West executed it on May 10, 1988, and the policies defined the Common Due Date was May 9, 1988. J231.

The application required the payment of an "Advance Premium" in the amount of $2 million, which was "5% of the estimated annual premium" under the individual Great West policies. The application stated that "[u]pon issuance of a Policy as of the Common Due Date, the premiums under this application should be considered premiums under such Policy." Great West and Dow had agreed that the first premiums under the individual policies would be credited to cash value and earn inside build-up from the effective date of the policies. The first premiums under the Great West policies in fact were credited to cash value and earned inside build-up from the Common Due Date. J239; Todd, Tr. at 888-90. Great West and Dow also agreed by the date of the application that the first premiums under the individual policies would be financed by policy loans to the maximum extent permitted by the policies as of the Common Due Date. Falla, Tr. (1/8 p.m.) at 32-33; White, Tr. (1/10 p.m.) at 22-23.

The policies were actually issued on June 20, 1988. Todd, Tr. at 738-40; J259. Dow paid the initial premiums due on May 9, 1988 using a combination of cash ($2 million) and a maximum loan. Todd, Tr. at 895-96; Ex. J312. On June 20, 1988 Great West delivered specimen policies to Dow. By October 12, Great West began to reconcile the consents it had received with the 4,393 policies' delivered to Dow in June. In November 1988, Great West discovered a clerical error made in connection with the specimen policies delivered to Dow in June 1988. As a result, Great West had to reprint the specimen policies to reflect the correct guarantee issue extras. Ex. J295; Todd, Tr. at 740-42.

For the MetLife plan, Dow applied for group life coverage on October 31, 1991. MetLife and Dow agreed by then that the first premium under the MetLife program would be credited to cash value and earn inside build-up from that

date. The first premiums under the MetLife policies in fact were credited to cash value and earned inside build-up from October 30, 1991. Ex. J643; Ex. J683. MetLife and Dow also agreed that any group policy issued to Dow would cover up to approximately 18,000 employees, that the first-year premium would be financed with maximum policy borrowing, that the variable policy loan interest rate would be set in reference to Moody's Corporate Average, and that the coverage and loan would be effective from that date if a policy was ultimately issued. By October 30, 1991, the essential terms of the loan already had been specified. MetLife agreed to estimate the premium due and loan available by using Dow's initial census of the entire population eligible for insurance in October 1991. Exs. J555, J559, J565, J577; Ryan, Tr. at 1692-94, 1750; Burdett, Tr. at 1460; Lake, (1/16 a.m.) Tr. at 547, 505-06, 515. It appears that the second policy issued for union employees was issued separately solely as an administrative convenience because the total number of insureds came within the original 18,000 contemplated by Dow and MetLife.

Because the administrative processing of the consents was not complete by October 30, 1991, Dow and MetLife determined that Dow should pay an estimated premium based on the number of estimated insureds and then would receive a premium adjustment for any employees who did not consent. J560; Ryan, Tr. at 1915, 1941. In a Memorandum of Record dated October 14, 1991, John Ryan of MetLife wrote that Dow decided 18,000 employees would be covered under a group plan with an effective date of October 31, 1991, even though the policy would be issued in December 1991. J564; Ryan, Tr. at 1689-90, 1698-99, 1826. When the final loan amounts were calculated, the initial premium payment dated October 30, 1991 was more than the

amount necessary to cover the unfinanced premium. Burdett, Tr. at 1463; Ex. J637; Ex. J643.

The Court is satisfied that the plaintiff has established by a preponderance of the evidence that bilateral obligations were created between Dow and its respective insurers as of the application dates for both programs. Insurance was issued, premiums were paid by real loans, policy value was created, and inside build-up was credited against the cash value created by the premium payment. The loans taken to finance the premium payments from the application dates were thus real debt obligations on which interest was due and paid. The loans as they were outstanding between the application and issue dates in both programs were not factual shams.

B. IRC Section 264 (4-of-7 Safe Harbor)

As noted earlier, in 1964 Congress limited the deductibility of interest on loans used to finance the purchase of life insurance. The controlling statute is 26 U.S.C. § 264, which states in part:

> (a) No deduction shall be allowed for—
>
> . . . .
>
> (3) Except as provided in subsection (c), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance . . . contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the

> increases in the cash value of such contract (either from the insurer or otherwise).
>
> . . . .
>
> (c) Exceptions.—Subsection (a)(3) shall not apply to any amount paid or accrued by a person during a taxable year on indebtedness incurred or continued as part of a plan referred to in subsection (a)(3)—
>
> (1) if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness. . . . For purposes of applying paragraph (1), if there is a substantial increase in the premiums on a contract, a new 7-year period described in such paragraph with respect to such contract shall commence on the date the first such increased premium is paid.

26 U.S.C. § 264 (1991).[7]

The plaintiff insists that the financing designs for the purchase of both its COLI plans complied with all the requirements set forth in the exception to the general rule prohibiting deductions for interest on policy loans. In arguing against this contention, the government mounts an attack on several fronts. First, the government observes that for Section 264 to apply at all, the contract must be a "life insurance contract" as defined by the IRC. Under the IRC,

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[7] The 1998 amendments to this statute moved subsection (c) to subsection (d). *See* Pub. L. 105-206, § 6010(*o*)(1) (1998).

"the term 'life insurance contract' means any contract which is a life insurance contract under the applicable [state] law," and which meets certain financial criteria. IRC § 7702(a). The government asserts that the Great West policies were not "life insurance contract[s]" under Michigan law[8] for two reasons: first, the Great West plan actually amounted to a group insurance contract issued at a time when Michigan law did not allow corporations to be the beneficiaries of employee group COLI plans; and second, at the time the Great West policies were issued, Dow did not have an insurable interest in the lives of all the employees as required by Michigan law. The government next argues that neither the Great West nor the MetLife plans satisfied the "4-of-7" rule because the partial withdrawals used to pay the premiums in years four through seven were shams, thereby violating the requirement implicit in Section 264(c) that the premiums in the first seven years be of equal amounts.

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[8] In its post-trial brief, the United States asserts for the first time that several of the employees covered under the Great West policies resided in Texas and Louisiana, and therefore the issue must be examined under the law of those states as well. The plaintiff objects to this argument as untimely. This issue was raised by the defendant as an affirmative defense to support a setoff if the Court were to order a refund. However, the amended answer phrases this affirmative defense in terms only of Michigan law. The Joint Final Pretrial Order similarly defines the issue in terms of Michigan law only. It is elementary that affirmative defenses that are not asserted timely are waived. *Scott v. Collins*, 286 F.3d 923, 927-28 (6th Cir. 2002). In addition, the Joint Final Pretrial Order outlines the issues to be tried; issues not described therein and not otherwise litigated are not properly before the court. *Life Care Ctrs. of Amer., Inc. v. Charles Town Assoc. Ltd. P'ship*, 79 F.3d 496, 507-08 (6th Cir. 1996). It appears that the parties did not engage in any discovery on this issue, except as it arises under Michigan law. Certainly, no proofs were offered at trial on the application of Louisiana's and Texas' group insurance and insurable interest requirements. The Court finds, therefore, that the issue was not raised in a timely fashion by the defendant, and therefore was waived, except as the question arises under Michigan law.

1. Whether the Policies Are "Insurance" Under State Law

a. Group v. Individual Policies

"Group insurance" is authorized by Section 4404 of the Michigan Insurance Code, which states:

> Group life insurance may be issued covering not less than 10 employees with or without medical examination, written under a policy issued to the employer or to the trustees of a fund established by the employer, the premium on which is to be paid by the employer, the employees, or by the employer and the employees jointly, and insuring only all of his or her employees, or all of any class or classes of employees determined by conditions pertaining to the employment, for amounts of insurance based upon some plan that will preclude individual selection, for the benefit of persons other than the employer. However, if the premium is to be paid by the employer and employee jointly and the benefits of the policy are offered to all eligible employees, not less than 75% of the employees may be so insured. This section does not require an employee to purchase group life insurance.

Mich. Com. Laws § 500.4404. Although not a definitional section, the statute sets forth many of the attributes required of group insurance. The Great West policies in this case were issued on individual, not group, forms, and were approved as such by the state insurance bureau. Nonetheless, the government contends that this Court should recharacterize the policies as group insurance because they

possess many of the traits commonly seen in group contracts, such as the absence of medical underwriting and individual selection, coverage of all employees in a "class," issuance of a single policy, socialization of insurance costs, an experience rating.

This argument is flawed because the policies issued by Great West did not possess all the features required of group insurance under Michigan law, and those attributes common to group policies could have been characteristics of individual policies as well. For instance, there was individual risk selection in the Great West plan since about a quarter of the employees covered underwent a medical review, adjustments in the benefit amount were made for age, and approximately thirty employees with a history of high-volume medical claims were excluded from coverage. Todd, Tr. at 727-31; Exs. J210, J255, J274, J251. Under the Great West program, there was no master policy or certificates issued to employees, although there was a specimen policy. The defendant points to the fact that individual policies were never delivered to the insured employees, but the employees were not the owners of the policies; Dow was. Great West viewed the plan as consisting of 4,051 individual policies and administered them as such, and the Michigan Insurance Bureau has never challenged that characterization. Dykhouse, Tr. at 2749. Finally, only management personnel who had attained a certain level of responsibility within the company were eligible for coverage. Thus "all of [Dow's] employees" were not included in the plan as required by Mich. Com. Laws § 500.4404. Since the employees occupied positions in various locations having to do with different job responsibilities, they did not constitute a class within Dow's workforce "determined by conditions pertaining to the employment."

The Court does not find a proper basis to recharacterize the policies Dow purchased from Great West as group insurance. The Michigan statutory prohibition against an employer being an owner and a beneficiary of an employee group policy, which was in effect in 1988 when the Great West plan was purchased, does not affect the status of the policies as "life insurance" under state law.

b. Insurable Interest

The question of insurable interest usually arises in disputes between the insurer and policyholder over the validity of an obligation to pay an insurance benefit. *See Hicks' Estate v. Cary*, 332 Mich. 606, 52 N.W.2d 351 (1952) (insurable interest rule may not be interposed by the deceased's widow to invalidate the right of a corporation to the proceeds of a life insurance policy owned by the corporation which formerly employed the deceased). The Court has not found a case which supports the general proposition advanced by the government here, which is whether a stranger to an insurance transaction can assail its validity under governing state law by claiming that the policyholder had no insurable interest in the insured life or property. However, the Michigan Supreme Court has held that a life insurance policy naming as a beneficiary one who has no insurable interest in the life of the insured was a wagering contract, contrary to public policy and void. *See Mutual Benefit Ass'n v. Hoyt*, 46 Mich. 473, 9 N.W. 497 (1881). It appears, therefore, that the presence of an insurable interest is a necessary component of a life insurance contract valid under state law and, therefore, IRC § 7702(a) as well.

In 1990, Michigan enacted legislation establishing an employer's insurable interest in the lives of its management and nonmanagement employees. *See* Mich. Comp. Laws §

500.2210 (1990). Before then, the public policy in this area was developed through judicial decisions. The plaintiff offered testimony from a former Michigan insurance commissioner as to his opinion of the public policy underlying the insurable interest rule. The Court does not find the testimony helpful, inasmuch as the question is principally a legal issue. *See Woods v. Lecureux*, 110 F.3d 1215, 1220 (6th Cir. 1997) (holding that expert testimony on ultimate issue of law is not helpful to the fact finder and inadmissible under the rules of evidence) (citing *Berry v. City of Detroit*, 25 F.3d 1342, 1353-54 (6th Cir. 1994)). The government argues that in the business context, Michigan's insurable interest rules limit employers to insuring the lives of only their "key persons." The government points to an opinion dated November 23, 1987 from a Michigan Insurance Bureau employee that a "key man" is one upon whose continued life "the success of the business is dependent." J138. This opinion is no more helpful than the plaintiff's expert testimony, and its impact on the development of Michigan's common law in the area is nil.

Michigan case law does not equate the insurable interest of a business in its employees with the concept of "key man" status. In fact, the term is not used in any of the major Michigan cases discussing insurable interests in one's employees or fellow businesspersons, and appears only in a few cases which discuss ancillary issues that just happen to have arisen in the context of a so-called key-man insurance policy. *See, e.g., G.P. Enters., Inc. v. Jackson Nat. Life. Ins. Co.*, 202 Mich. App. 557, 509 N.W.2d 780 (1993) (informing agent orally of change in health when delivering policy did not comply with terms of application for key-man insurance); *All Amer. Life & Cas. Co. v. Oceanic Trade Alliance Council Int'l, Inc.*, 756 F.2d 474 (6th Cir. 1985) (affirming verdict entered against insurer who refused to tender proceeds to key-man life insurance policy, alleging

that insured was murdered by fellow stockholders and employees); *Johnson v. Primerica Life Ins. Co.*, 34 F. Supp. 2d 562 (W.D. Mich. 1998) (finding that insurer improperly permitted corporate officers lacking actual authority under Michigan law to alter the beneficiary on a key-man life insurance policy taken out by the company); *Secor v. Pioneer Foundry Co.*, 20 Mich. App. 30, 173 N.W.2d 780 (1969) (recognizing that one who possesses an insurable interest in a contract at the time of purchase can still collect on that contract after that insurable interest has terminated by separation from employment – "key man" contract was at issue).

Rather, an "insurable interest" "is broadly defined as being present when the person has an interest in property, as to the existence of which the person will gain benefits, or as to the destruction of which the person will suffer loss." *Universal Underwriters Group v. Allstate Ins. Co.*, 246 Mich. App. 713, 726, 635 N.W.2d 52, 59 (2001) (citing *Crossman v. Amer. Ins. Co.*, 198 Mich. 304, 309, 164 N.W. 428 (1917)). Michigan has and continues to recognize the general principle that one obviously has an insurable interest in one's own health and well-being. *Id.* at 727, 635 N.W.2d at 59-60 (holding that buyer has insurable interest in vehicle entitling her to personal injury protection benefits even if she was not its owner at the time of the accident); Dykhouse, Tr. at 2705. The common law on the existence *vel non* of an insurable interest in the health and well-being of *others*, however, has grown from the public policy prohibiting wagering on the lives of strangers, which dates back to English laws passed centuries ago. *See Crossman*, 198 Mich. at 308, 164 N.W. at 429 ("Policies of insurance founded upon mere hope and expectation and without some interest in the property, or the life insured, are objectionable as a species of gambling, and so have been called wagering policies. All species of gambling policies were expressly

prohibited in England by St. 19 Geo. II, c. 37, and have been treated as illegal in this country upon the principles of that statute, without acknowledging it as authority.") The question since then is how far one can come to that line without passing over it. Two Supreme Court cases from the late nineteenth century have substantially influenced the law of several states in this area, including Michigan. In *Warnock v. Davis*, 104 U.S. 775 (1881), the executor of the deceased's estate sued members of a trust association who had taken out a policy of life insurance on the deceased and secured a waiver from the deceased for its proceeds. The Court recognized that the policy could validly have been assigned to the trust association as security for a debt, but found that it could not validly be assigned to the association for any other purpose because the association lacked an insurable interest in the deceased's life. *Id.* at 778-79. The Court recognized that pecuniary loss was one measure of an insurable interest, but emphasized that it was not the only factor to be considered:

> It is not easy to define with precision what will in all cases constitute an insurable interest, so as to take the contract out of the class of wager policies. *It may be stated generally, however, to be such an interest*, arising from the relations of the party obtaining the insurance, either as creditor of or surety for the assured, or from the ties of blood or marriage to him, *as will justify a reasonable expectation of advantage or benefit from the continuance of his life.* It is not necessary that the expectation of advantage or benefit should be always capable of pecuniary estimation; for a parent has an insurable interest in the life of his child, and a child in the life of his parent, a husband in the life of his wife, and a wife in the life of

> her husband. The natural affection in cases of this kind is considered as more powerful – as operating more efficaciously – to protect the life of the insured than any other consideration. *But in all* cases *there must be a reasonable ground, founded upon the relations of the parties to each other, either pecuniary or of blood or affinity, to expect some benefit or advantage from the continuance of the life of the assured.* Otherwise the contract is a mere wager, by which the party taking the policy is directly interested in the early death of the assured. Such policies have a tendency to create a desire for the event. They are, therefore, independently of any statute on the subject, condemned, as being against public policy.

Id. at 779 (emphasis added).

Shortly after *Warnock*, the Court heard the case of *Connecticut Mutual Life Insurance Co. v. Luchs*, 108 U.S. 498 (1883). In that case, Luchs sued the defendant insurance company for the death benefit from a policy of life insurance he has purchased on the life of his partner, Dillenberg. The partnership they had formed required the contribution of both services and capital. Because Dillenberg had failed to timely contribute his portion of the capital required, an insurance agent suggested a life insurance policy to cover the outstanding balance, which was subsequently procured. The insurance company claimed that Luchs lacked an insurable interest in the life of Dillenberg, but the Court rejected this argument, as "Dillenberg was his partner and had not paid his promised proportion of the capital of the concern." *Id.* at 505. Furthermore, the Court suggested that aside from the debt, Luchs had a pecuniary interest in the mere continuance

of the partnership, which he expected to result in financial rewards. *Id.* at 506. Accordingly, the interest was valid, and the Court affirmed a lower-court ruling awarding the proceeds to the plaintiff.

Both Supreme Court cases were subsequently cited by the Michigan court in *Sun Life Assurance Co. of Canada v. Allen*, 270 Mich. 272, 259 N.W. 281 (1935). In that case, partners in the Hand Baking Company took out life insurance policies on each others' lives. After realizing that members of the partnership were dying off, the insurance company denied a claim upon a Mr. Cap, and sued in equity for rescission of the insurance contract. The Court found that Cap was never a true partner in the Hand Baking Company, but essentially an employee awarded a partnership only for the purpose of collecting life insurance. Consequently, its members had no insurable interest in his life. "The mere existence of a legal partnership does not establish an insurable interest," and it was "impossible to hold that the partnership could have suffered so substantial a loss upon the death of Cap as to prefer his continued services to the insurance money." *Id.* at 278, 279. Citing both of the aforementioned Supreme Court cases, the Michigan Court concluded that the required pecuniary interest in Cap was lacking, and that the policy was void.

Taken by itself, *Sun Life* might suggest that Michigan courts would look only to the pecuniary effect of an insured's loss to determine an insurable interest. The United States Court of Appeals for the Sixth Circuit, however, did not read that case as limiting the definition set forth in *Warnock* and *Luchs* when it decided *Indemnity Ins. Co. of North America v. Dow*, 174 F.2d 168 (6th Cir. 1949). In that case, the plaintiff Dow sought the proceeds of a life insurance policy he had taken out on Marsha Kruger, an airplane pilot with whom he had begun a joint venture to

offer charter flights. Dow invested the money, and hired Kruger was to handle the operations. The insurance company denied payment, arguing that Dow lacked any insurable interest in his employee. Applying Michigan law, the Sixth Circuit rejected this argument. The Court noted that the *Sun Life* court had cited *Warnock* and *Luchs* with approval, and concluded that because the Michigan court did not explicitly reject the more generous definitions cited in those cases, Dow had a proper insurable interest:

> It was not necessary to prove that the death of the insured resulted in a substantial loss to the beneficiary in this case, that he would suffer therefrom 'a substantial pecuniary loss,' or that his insurable interest is established only when he shows pecuniary loss in fact, as contended here by appellant. It is sufficient that the beneficiary has a reasonable expectation of some benefit or advantage from the continuance of the life of the assured.

Id. at 170 (referencing *Warnock*, 104 U.S. at 779).

No Michigan case has constricted this definition, and, in fact, the Michigan Court of Appeals has somewhat relaxed the standard when, in *Secor*, it held that a business could recover on a policy of life insurance on a former employee's life even after its insurable interest had disappeared. 20 Mich. App. at 35-37, 173 N.W.2d at 783-84. This Court concludes that the correct test for determining whether an employer has an insurable interest in its employees' lives is whether it "has a reasonable expectation of some benefit or advantage from the continuance of the life of the" employee. *Dow*, 174 F.2d at 170. The Court believes this test would be applied by the Michigan Supreme Court in determining the question under state law. *See Ziegler v. IBP Hog Market,*

Inc., 249 F.3d 509, 517 (6th Cir. 2001) (holding that while the district court should consult "all available data" in predicting a likely holding of a state's highest court, decisions from that state's intermediate appellate courts must be followed unless the Court is convinced the state supreme court would rule differently).

In this case, Dow proved at trial that it actually reduced the number of proposed insureds in the Great West plan from approximately 20,000 employees because of concerns over the insurable interest rule. White, Tr. (1/10 p.m.) at 19, 46. The 4,051 that were insured in the 1988 program were all management personnel earning over $50,000 annually. Under its Hay Point system, Dow had determined that those employees who had merited 238 points were present and future leaders, became eligible for certain executive level benefits (such as stock options), and held positions of responsibility in various locations throughout the company. Moreover, all of the employees consented to coverage, which further vindicates the public policy designed to prevent wagering contracts on which the insurable interest rule is grounded. Dow has established by a preponderance of the evidence that it had a reasonable expectation of some benefit or advantage from the continued employment, and more importantly, the continued vitality, of those employees. The Court therefore rejects the government's contention that Dow did not have an insurable interest in these employees, and that the Great West contracts did not qualify as "life insurance" under state law for the purpose of IRC § 7702(a).

2. Payment of Premiums

The core requirement of the 4-of-7 Rule contained in IRC § 264(c)(1) is that policy loans cannot be used to finance premium payments for more than three of the first

seven years of a policy. There is no express language in the statute that requires premiums in years four and later to be at least as much as the premiums in the earlier years. The government contends, however, that there is a requirement "implicit" in this section that the amount of the premiums in the first seven years be the same. Dow disagrees. This is a pivotal issue, since the Court has found that the partial withdrawals were factual shams, and that for tax purposes the only legitimate payment of the premiums in years four through seven consisted of the cash portion, which was about 10% of the nominal premium total. If Section 264(c)(1) includes a level premium requirement, neither of Dow's COLI plans complied with it.

The district court in *AEP* held that Section 264(c)(1) contained a level premium requirement, but only after the policyholder conceded the issue. *See AEP*, 136 F. Supp. 2d at 783. The court in *CM Holdings* likewise reached this same conclusion, although the policyholder in that case did not contest it either. *CM Holdings*, 254 B.R. at 645-46. The court reasoned that although Congress failed to anticipate the circumstance of an insured financing large premiums in the first three years and paying much smaller premiums in cash in the next four years, it specifically prohibited the opposite financing structure, and therefore must have intended to require level premiums in all seven years. *Ibid.* The court also cited Treasury Regulation 1.264-4(c)(1)(ii), which states that "if the stated annual premiums due on a contract vary in amount, borrowing in connection with any premium, the amount of which exceeds the amount of any other premium, on such contract may be considered borrowing to pay premiums for more than one year," 26 C.F.R. 1.264-4(c)(1)(ii), to support its conclusion. *CM Holdings*, 254 B.R. at 646.

I must respectfully disagree with these decisions, because I believe they contravene fundamental rules of statutory construction. There is little doubt that Congress did not anticipate a policy acquisition scheme in which premiums are frontloaded, as the court in *CM Holdings* observed. But the existence of a tax loophole left by Congress is not itself a justification for a judicial plug crafted from "implicit requirements." *See Cen-Tex, Inc.*, 377 F.2d at 690-92.

To the contrary, I believe that the plain language of Section 264(c) counsels against reading a level premium requirement into it, when it already explicitly covers single premiums and increasing premiums, but omits any reference to *decreasing* premiums. When construing statutes, the court's "task is to give effect to the will of Congress, and where its will has been expressed in reasonably plain terms, that language must ordinarily be regarded as conclusive." *Negonsott v. Samuels*, 507 U.S. 99, 104 (1993). Above all other principles, "courts must presume that a legislature says in a statute what it means and means in a statute what it says there." *Conn. Nat. Bank v. Germain*, 503 U.S. 249, 253-54 (1992). The language of Section 264 is plain and unambiguous. Section 264 generally prohibits the deduction of any interest paid on indebtedness incurred to carry life insurance, "[e]xcept as provided in subsection (c)." 26 U.S.C. § 264(a)(3) (1991). Subsection (c) contains four exceptions to the rule expressed in subsection (a)(3), only one of which applies to this case, subsection (c)(1). That section provides a safe harbor for such interest paid provided that "no part of 4 of the annual premiums due during the 7-year period . . . is paid under such plan by means of indebtedness." 26 U.S.C. § 264(c)(1) (1991). At the end of subsection (c), this safe harbor is qualified by the proviso that any "substantial *increase* in the premiums on a contract" will trigger the beginning of a new seven-year period. 26

U.S.C. § 264(c) (1991) (emphasis added). In other words, taxpayers may not backload premiums. There is no equivalent provision forbidding the frontloading of premiums with decreasing amounts over the seven year period. Thus, the plain language of the statute does not prohibit such frontloading.

This interpretation is also counseled by the statutory rule of construction that "the expression of one thing is to the exclusion of the other." *Nat'l Truck Equip. Ass'n v. Nat'l Highway Traffic Safety Admin.*, 972 F.2d 669, 674 (6th Cir. 1992). "Where Congress explicitly enumerates certain exceptions to a general prohibition, additional exceptions are not to be implied, in the absence of evidence of a contrary legislative intent." *TRW Inc. v. Andrews*, 534 U.S. 19, 28 (2001). For that reason, "[w]hen Congress provides exceptions in a statute, it does not follow that courts have authority to create others. The proper inference . . . is that Congress considered the issue of exceptions and, in the end, limited the statute to the ones set forth." *United States v. Johnson*, 529 U.S. 53, 58 (2000). *See generally Textron, Inc. v. Comm'r*, 117 T.C. 67, 75-76 (2001) (applying this rule to find that by incorporating constructive ownership in one subsection of a statute, but not another, Congress obviously intended the concept of "ownership" to be distinct in each section).

No rule is absolute, however, and this maxim against implied exclusions can and must yield when "other circumstances evidencing congressional intent [] overcome[s] the[] force" of the canons of statutory construction. *Chickasaw Nation v. United States*, 534 U.S. 84, 94 (2001) (noting that "specific canons" of statutory interpretation "are often countered by some maxim pointing in a different direction"). *See also United States v. Vonn*, 535 U.S. 55 (2002). Furthermore, despite language in more

recent cases to the contrary,[9] the Supreme Court has recognized that in very unique circumstances, particularly compelling legislative history can overcome the plain language of a statute. *See Harrison v. Northern Trust Co.*, 317 U.S. 476 (1943). In *Harrison*, the Court granted certiorari to a lower court decision awarding the plaintiffs substantial sums of money free of the estate tax. The court of appeals had affirmed a verdict for the plaintiffs, finding that Congress's use of the phrase "payable out of" was governed by a previous Supreme Court decision that preceded the statute in question. Finding, however, that "words are inexact tools at best," the Court explained that "there is wisely no rule of law forbidding resort to explanatory legislative history no matter how clear the words may appear on superficial examination." *Id.* at 479 (citations omitted). Upon examining the legislative history, the Court found in the applicable House Report clear evidence that the statute was actually intended to *overrule* the case on which the lower court had relied. Finding this history to be "conclusive in favor of the Government's contention," the Supreme Court reversed the judgment of the lower court and remanded for further proceedings. *Id.* at 480.

There is no evidence here, however, much less evidence as compelling as that in *Harrison*, indicating that Congress intended to impose a level premium requirement on taxpayers seeking to use the four-of-seven safe harbor provision of Section 264(c)(1). The *CM Holdings* Court referenced a report indicating that Congress sought "to prevent avoidance of this provision by taking out a contract

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[9] *See Barnhart v. Sigmon Coal Co.*, 534 U.S. 438 (2002) ("When the words of a statute are unambiguous, then, this first canon is also the last: judicial inquiry is complete."); *see also Ratzlaf v. United States*, 510 U.S. 135, 147-48 (1994) (holding that the Court would "not resort to legislative history to cloud a statutory text that is clear").

with very low premiums for the first 4 years, with the premiums being substantially greater thereafter." S. Rep. No. 830 (1964), *reprinted in* 1964 U.S.C.C.A.N. at 1751-52. *See CM Holdings*, 254 B.R. at 645. However, this passage does not suggest an intent to include a level premium requirement, nor does it furnish justification to judicially amend the statute.

The Supreme Court has emphasized that judges must "ordinarily resist reading words or elements into a statute that do not appear on its face." *Bates v. United* States, 522 U.S. 23, 29 (1997). "Deciding what competing values will or will not be sacrificed to the achievement of a particular objective is the very essence of legislative choice – and it frustrates rather than effectuates legislative intent simplistically to assume that *whatever* furthers the statute's primary objective must be the law." *Rodriguez v. United States*, 480 U.S. 522, 526 (1987) (rejecting lower court finding that passage of mandatory reincarceration law for probation violators must have removed federal judges' authority to suspend those sentences). "Courts are not authorized to rewrite a statute because they might deem its effects susceptible of improvement," *Badaracco v. Commissioner*, 464 U.S. 386, 398 (1984), nor can they "draw on some unexpressed spirit outside the bounds of the normal meaning of words." *Addison v. Holly Hill Fruit Prods.*, 322 U.S. 607, 617 (1944). *See also id.* ("Legislation introducing a new system is at best empirical, and not infrequently administration reveals gaps or inadequacies of one sort or another that may call for amendatory legislation. But it is no warrant for extending a statute that experience may disclose that it should have been made more comprehensive. The natural meaning of words cannot be displaced by reference to difficulties in administration.")

The authors of the 1964 tax bill could easily have contemplated that taxpayers would take advantage of the safe harbor through both rising *and* declining premium schedules. To assume otherwise gives too little credit to the congressional wit. *See Addison*, 322 U.S. at 618 ("The idea which is now sought to be read into the grant by Congress to the Administrator to define 'the area of production' beyond the plain geographic implications of that phrase is not so complicated nor is English speech so poor that words were not easily available to express the idea or at least to suggest it."). Nor does the Treasure Regulation cited by the *CM Holdings* court (Treas. Reg. 1.264-4(c)(1)(ii) imply a level premium requirement.) Rather, the passage *recognizes* that premiums need not be level – something that is only possible if subsection (c) does not prohibit declining premiums – and provides an independent check to ensure that debt borrowing for one year will not mask the figures in other years, which is a potential infirmity not raised by the government in this case. Even if the *CM Holdings* court is correct, and this treasury regulation somehow was intended to expand the statutory text in subsection (c), the regulation would be contrary to the plain language and intent of the statute. Unambiguous statutes leave the agency with no interpretive role to play. *See Barnhart*, 534 U.S. at 462 (declining to give effect to agency interpretation of statute whose text was unambiguous both in its plain language and through the statutory maxim of implied exclusion).

Neither the plain text nor principles of statutory interpretation support the proposition that 26 U.S.C. § 264(c)(1) contains an "implicit" level premium requirement. The legislative history cited by the *CM Holdings* court suggests no smoking gun like that in *Harrington*, where the committee report indicated a particular intent to overturn the case on which the lower courts has relied. I do not find patently "absurd" Congress's decision to permit declining

premiums but bar those that substantially increase. Finally, to the extent that there is any "implicit" intent in the legislative history of this statute to bar declining premium plans, no court has the authority to rewrite a statute simply because, in that court's opinion, it could have been better written. Legislators speak through their statutes, not their committee reports. *City of Chicago v. Envtl. Def. Fund*, 511 U.S. 328, 337 (1994).

Thus, although the premiums Dow actually paid in years four through seven in each of the plans were substantially less than those paid by means of policy loans in the first three years, those declining premiums do not disqualify the plan from the safe harbor of 26 U.S.C. § 264(c).

III. Conclusion

The Court finds that Dow has established by a preponderance of the evidence that both its Great West and MetLife COLI plans were imbued with economic substance. They had substantial effects on the beneficial interest of the taxpayer apart from the income tax deductions. The plaintiff has established by a preponderance of the evidence that the policy loans were real transactions consistent with commercial norms, and therefore were not factual shams. Nor was any phantom interest paid on any portion of the policy loans in the first year of either plan. However, since the unencumbered cash value in the policies at the beginning of the fourth through seventh years was zero, and there was nothing available to withdraw or to offset against the premium obligation, the partial withdrawals were not real and constituted shams in fact.

There is no basis for requiring the recharacterization of the Great West policies as group insurance. Furthermore,

Dow had an insurable interest under Michigan law in the lives of all of the employees covered under that plan. The Great West plan satisfied the definition of "insurance" under state law for the purpose of IRC § 7702(a).

Finally, because IRC § 264(c) does not contain a level premium requirement, both of Dow's COLI plans complied with the statutory requirements despite the fact that the premium payments in years four through seven by means of partial withdrawals were deemed factual shams.

The Internal Revenue Service improperly disallowed Dow's deductions for interest and expenses claimed on Dow's 1989, 1990 and 1991 tax returns in connection with its corporate owned life insurance plans purchased from Great West and MetLife.

Accordingly, it is **ORDERED** that the plaintiffs' Motion to Strike Appeals Protests From Record at Trial [dkt #61] is **GRANTED**.

It is further **ORDERED** that judgment will enter in favor of the plaintiffs in the amount of $22,209,570, plus interest.

JUDGMENT

This matter came on for trial before the Court sitting without a jury. The Court has this day filed an opinion containing its findings of fact and conclusions of law in accordance with Federal Rule of Civil Procedure 52, concluding that the plaintiff has sustained its burden of proof and is entitled to a judgment against the defendant.

Accordingly, it is **ORDERED AND ADJUDGED** that the plaintiff shall recover from the defendant the sum of $22,209,570, plus interest allowed by law, and costs of the action, to be taxed.

APPENDIX C

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
NORTHERN DIVISION

No. 00-10331-BC

THE DOW CHEMICAL COMPANY
AND SUBSIDIARIES,
Plaintiffs,

v.

UNITED STATES OF AMERICA,
Defendant.

OPINION AND ORDER GRANTING IN PART AND DENYING IN PART DEFENDANT'S MOTION TO AMEND JUDGMENT AND FOR ADDITIONAL FINDINGS AND GRANTING CERTAIN PROCEDURAL MOTIONS

FILED IN THE U.S. DISTRICT COURT
EAST. DIST. MICH. BAY CITY
AUGUST 12, 2003, 12:20 P.M.

HONORABLE DAVID M. LAWSON

John B. Magee, Richard C. Stark, Raj Madan, Sheri Dillon, and Mark Nelson, McKee Nelson LLP, Washington DC, and Valorie Gilfeather, Midland, MI, for Plaintiff

Dennis M. Donohue, Joseph A. Sergi, Alex E. Sadler, Nicole M. Bielawski, Maggie O'Shaughnessy, Department of Justice, Tax Division, Washington, DC, and James A. Brunson, U.S. Attorney's Office, Bay City, MI, for defendant.

On March 31, 2003, this Court entered judgment in favor of the taxpayer, plaintiff Dow Chemical Company and its subsidiaries ("Dow"), in this civil action seeking a refund of monies the plaintiffs paid to the United States Treasury to cover deficiencies assessed by the Internal Revenue Service after it disallowed deductions claimed by Dow for the interest paid on loans taken to pay premiums on corporate-owned life insurance policies ("COLI"). This matter is before the Court on the government's motion seeking amendment of the Court's judgment pursuant to Rule 59(e) of the Federal Rules of Civil Procedure and additional factual findings in support of this amendment pursuant to Rule 52(b). Procedural motions related to the briefing of these post-trial issues have also been filed by both parties.

The government argues, in essence, that the Court failed to fully appreciate – and rule upon – the consequences that logically flowed from the Court's determination that partial withdrawals taken to pay policy premiums for certain years in both COLI plans at issue were factual shams. The government also invites the Court to expand the basis for reconsideration and reassess its conclusion that the two COLI plans did not constitute economic shams in light of a recent Sixth Circuit ruling. The Court agrees with the government that the logical extension of the finding that the

partial withdrawals are factual shams likely leads to the conclusion that loan interest was not paid in years four through six of each of the plans, and that the plans thereby would have terminated by their own terms. However, that did not happen in reality: the parties treated the policies as continuing in full force, and treated the partial withdrawals, and premium and interest payments in plan years four, five, and six, as if they really happened. In light of the gloss on the law relating to factual shams recently set forth by the Sixth Circuit, following an earlier Third Circuit decision relating to COLI plans, the Court accepts the government's invitation to *sua sponte* expand the basis for reconsideration of this Court's Opinion, but not in the manner the government seeks. The Court will vacate its original finding that the partial withdrawals taken in years four through seven of the COLI plans were factual shams, and otherwise deny the government's Rule 59(e) and 52(b) motion. The Court believes that its treatment of the economic sham issue was correct, and will not alter its opinion or judgment as to those findings and conclusions.

I.

As previously mentioned, the Court filed its opinion and judgment in favor of the plaintiff on March 31, 2003 and ordered a refund of taxes paid. Specifically, the Court concluded that the two COLI plans at issue, issued by Great West Life Assurance Company and Metropolitan Life Insurance Company respectively, were not economic shams and, in most respects, did not rely on factual shams to generate deductions for policy loan interest. The sole exception was the partial withdrawal device utilized by Dow and the two insurance companies to pay 90% of the premiums due in years four through seven of both plans, which the Court found to be a factual sham because it called for withdrawal of encumbered policy value contrary to the

terms of both plans, and thus sanctioned the withdrawal of funds that were not available for that purpose, according to the written documents that constituted the parties' agreements. This finding left Dow with a substantial reduction in the amount of premium payments that the Court found were actually made in plan years four through seven. Nonetheless, the Court found Dow could still deduct the policy loan interest under the terms of the Internal Revenue Code because the financing strategy did not contravene the so-called "four-of-seven safe harbor," which the Court interpreted not to require level premium amounts over the relevant period when premium payments substantially declined over the course of the first seven years of the life insurance policy.

The government responded to the Court's Judgment, and its findings and conclusions of law memorialized in its Opinion and Order, by timely filing a motion seeking amendment of the judgment pursuant to Rule 59(e) of the Federal Rules of Civil Procedure, and additional findings of fact pursuant to Rule 52(b) to support any decision to amend the judgment. Dow filed a brief in opposition to the request for additional factual findings, and noted that a response to the Rule 59(e) portion of the motion was not permitted absent leave of the Court. The government replied by tendering a proposed eight-page reply brief along with a motion to permit a reply brief of eight pages in length and a request for the Court to *sua sponte* expand the basis of the Rule 59(e) motion to encompass changes to be made to the Court's Opinion in light of the Sixth Circuit's opinion in *American Electric Power Co. v. United States*, 326 F.3d 737 (6th Cir. 2003), decided four weeks after the opinion in this case was filed.

Dow responded to the government's latest filing with a brief opposing the expanded reply brief and also opposing

any briefing of the Sixth Circuit's *AEP* decision, asserting that such briefing was unnecessary and inappropriate. Dow also tendered a motion to file this response out-of-time. The parties have since submitted a stipulation permitting Dow to file this response brief out of time.

II.

Federal Rule of Civil Procedure 59(e) provides: "Any motion to alter or amend a judgment shall be filed no later than 10 days after entry of the judgment." The decision of whether to grant relief under Rule 59(e) is discretionary with the district court. *Davis by Davis v. Jellico Cmty. Hosp., Inc.*, 912 F.2d 129, 132 (6th Cir. 1990). Such a motion will generally be granted if the district court made a clear error of law, if there is an intervening change in the controlling law, or if granting the motion will prevent manifest injustice. *GenCorp, Inc. v. Am. Int'l Underwriters*, 178 F.3d 804, 834 (6th Cir. 1999). A Rule 59(e) motion is not properly used as a vehicle to re-hash old arguments or to advance positions that could have been argued earlier, but were not. *Sault Ste. Marie Tribe of Chippewa Indian v. Engler*, 146 F.3d 367, 374 (6th Cir. 1998). Once a timely motion has been filed under this Rule, the district court has the discretion to reconsider any part of its final opinion and judgment, not only those sought to be corrected by the moving party. *EEOC v. United Ass'n of Journeyman & Apprentices*, 235 F.3d 244, 250 (6th Cir. 2000).

Federal Rule of Civil Procedure 52(b) provides that "[o]n a party's motion filed no later than 10 days after entry of judgment, the court may amend its findings – or make additional findings – and may amend the judgment accordingly. The motion may accompany a motion for a new trial under Rule 59." The basis for such a motion is similar to that raised under Rule 59(e), and therefore also

rests within the district court's sound discretion. *Hollis v. City of Buffalo*, 189 F.R.D. 260, 262 (W.D.N.Y. 1999). Relief under this section is appropriate in cases of manifest factual error, if newly discovered evidence is available, or where further action by the Court would clarify the record for appeal. *Ibid.* Once again, Rule 52(b) may not be used by the parties simply to relitigate issues already decided or matters that could have been raised earlier. *Diebitz v. Arreola*, 834 F. Supp. 298, 302 (E.D. Wis. 1993). As the text of the Rule makes clear, it is not at all unusual for a Rule 52(b) motion to accompany a Rule 59(e) motion in matters tried to the Court. *Ibid.* Erroneous factual findings need not be amended under this rule if they are immaterial to the case's ultimate disposition. *Dow Chem. Pac. Ltd. v. Rascator Maritime S.A.*, 609 F. Supp. 451, 453 (S.D.N.Y. 1984).

The defendant's motion in this case was brought in good faith and is properly lodged under Rules 52(b) and 59(e). This was an extremely complicated case in which the Court resolved some of the pertinent issues in a manner that differed from the propositions advanced by the government. As a result, significant portions of the Court's reasoning were not subjected to analysis by the parties, and now deserve a second look in light of the Court's gloss on the issues presented. The Court believes that the defendant has properly limited itself to challenging aspects of the Court's reasoning not previously discussed by the parties, and thus properly brings its motion under Rules 52(b) and 59(e).

A.

The government argues that the Court did not properly carry through its reasoning that the partial withdrawals used to pay premiums in years four through six of both COLI plans were factual shams. The government

observes that if the partial withdrawals were shams in fact, then not only were the premiums not paid for those years (except for that portion paid in cash, about 10% of the total amount due), but also the interest payments for those years remained unpaid. The government further contends that Dow should not be permitted to deduct the interest for those years, since it was never paid as a result of shamming the partial withdrawals. Further, the argument continues, if the interest is unpaid, the Great West and MetLife policies terminated in the fourth policy year by their own terms as a result of the failure to pay loan interest. The base policy for Great West provides that the "policy will terminate when the indebtedness equals or is more than the cash surrender value plus any dividend credits." Ex. J1147, Base Policy Form Number X105, at 11. The base policy for MetLife states that the "Group Policy will terminate" if loan interest is not repaid and "the Cash Surrender Value is insufficient to pay the Monthly Deduction due on a Monthly Date." Ex. J593 at 11. In both cases, because the payments made on loan interest were factual shams based on encumbered funds that did not exist for this purpose, the argument goes, the policies terminated by their own operation.

The problem with this argument is that the scenario that the government posits in theory never in fact occurred. Under both the Great West and MetLife COLI plans, the policies remained in force well after the fourth policy year, policy loans continued in year seven and beyond, premiums were paid by Dow and the insurance companies paid state taxes on those premiums, death benefits continued to be paid, and the economic consequences of policies-in-force continued to be realized and acknowledged by both parties. In other words, it appears that the transactions actually occurred, despite the fact that the partial withdrawals contravened the express terms of the insurance contracts, as previously determined by the Court. *See Dow v. United*

States, 250 F. Supp. 2d 748, 811-12 (E.D. Mich. 2003). Given these facts, and in light of *dicta* in *In re CM Holdings*, 301 F.3d 96, 108 (3d Cir. 2002), and *American Elec. Power Co. v. United States*, 326 F.3d 737, 745 (6th Cir. 2003), the Court feels compelled to reexamine its holding that the partial withdrawals were factual shams.

In its Opinion filed March 31, 2001, the Court described the sham-in-fact doctrine as follows:

> In deciding whether a transaction is a sham in fact, the Court examines the nature and form of the transaction to determine what actually occurred. In making this assessment, the Court "will ignore accounting tricks and other transactional artifices." *CM Holdings*, 254 B.R. [578], 600 (D. Del. 2000) (quoting *Peerless Indus., Inc. v. United States*, 1994 WL 13837 at *4 (E.D. Pa.), *aff'd*, 37 F.3d 1488 (3rd Cir. 1994)). The Court considers whether appropriate business formalities are employed, industry customs and practices are followed, and there is compliance with relevant commercial norms. Thus, paper transactions which solely attempt to create deductible losses or expenses are not recognized. *Woolford Realty v. Rose*, 286 U.S. 319, 330 (1932) (stating that "[t]he mind rebels against the notion that Congress . . . [was] willing to foster an opportunity for juggling so facile and so obvious"). But transactions involving two or more parties which are grounded in commercial custom and have present or future economic consequence to one or more parties will be

> recognized. *See CM Holdings*, 254 B.R. at 600 and cases cited therein.

Dow, 250 F. Supp. 2d at 811-12. As this Court noted in its opinion, the district court in *CM Holdings* found the loading dividends used to finance premiums in years four through seven of the COLI policies in that case to be factual shams on the basis that they did not conform with industry practice:

> In order to calculate the dividend amounts, the policies charged administrative fees considerably out of proportion to the actual costs incurred. Furthermore, instead of distributing the dividend from accumulated surplus, the policies "sourced" their dividends from excessive loading charges which were instantaneously offset against payment of the premium. The lack of any contributions to the dividends from investment yields was also suspicious. The district court was also troubled by the payment of the dividends at the beginning of the policy year, rather than the industry-standard practice of paying at the end of the year. The legitimacy of the dividends was further compromised by the fact that they were guaranteed, not contingent. Topping it off, the designers of the COLI plan did not treat the dividends as a liability on its balance sheets. The combination of all these factors provided "overwhelming evidence" to the district court that the loading dividends were factual shams.

Id. at 760-61 (citing *CM Holdings*, 254 B.R. at 617-20). Although the Third Circuit affirmed the lower court's opinion that the COLI plan was a sham in substance, thus

disposing of the case, it found in *dicta* that the lower court had erred in concluding that the loading dividends were factual shams. Factual shams, the Third Circuit made clear, are transactions that never occurred, not transactions that did occur, but were improper by industry standards. *In re CM Holdings*, 301 F.3d 96, 108 (3d Cir. 2002). The Court suggested an exception to this rule where the transaction in question was plainly "performed in violation of some of the background assumptions of commercial dealing, for example arms-length dealing at fair market values," *id.* (citing *Horn v. Commissioner*, 968 F.2d 1229, 1236 n.8 (D.C. Cir. 1992)). Generally speaking, however, the impropriety of a transaction with regard to standard "industry practice" is evidence of an overall economic sham, not an illusory transaction in and of itself. *Id.*

The findings of the district court and Sixth Circuit in the *American Electric Power* case follow the same pattern. Relying heavily on the analysis of the *CM Holdings* district court, the district court in *American Electric Power, Inc. v. United States*, 136 F. Supp. 2d 762, 782-83 (S.D. Ohio 2001), concluded that the loading dividends in that COLI plan were also factual shams, finding the basis for the dividends to have no reasonable grounding in the actual costs of administering the policies and generally inconsistent with industry norms. On review, the Sixth Circuit, having affirmed that AEP's COLI plan was an economic sham, agreed with the Third Circuit, again in *dicta*, that the lower court's factual sham analysis was problematic. *See American Elec. Power Co. v. United States*, 326 F.3d 737, 745 (6th Cir. 2003). Citing *Kennedy* v. *Commissioner*, 876 F.2d 1251 (6th Cir. 1989) and *Forseth v. Commissioner*, 85 T.C. 127 (1985), the Sixth Circuit noted that both cases found certain transactions to be factual shams because the monies paid had no purpose other than to create tax deductions and were not actually expended for their stated

use. In other words, "the purported transactions in those cases on which the taxpayers claimed deductions had not actually occurred," and were thus factual shams. 326 F.3d at 745. However, the Sixth Circuit found no evidence that the loading dividend transactions in the AEP plan, even if accomplished by circular netting transactions, "did not actually occur." *Ibid.* The court of appeals thus stated that in suggesting that noncompliance with industry practice was sufficient to support a factual sham finding, the district court appeared "to be extending the factual-sham doctrine beyond its generally accepted definition." *Ibid* (adopting the Third Circuit's finding in this regard from *CM Holdings*, 301 F.3d at 108).

Thus, two Circuit Courts of Appeals, one of which is the Circuit Court whose rulings bind this Court, have provided a definition of factual sham that all but disregards the propriety of the transaction in question in favor of an analysis that focuses simply on whether the transactions actually occurred. To be sure, both decisions made these findings in *dicta*. Nonetheless, although *dicta*, the Sixth Circuit's conclusions with regard to the loading dividends used in the *AEP* policies signal that the scope of this Court's factual sham analysis, which took into account "whether appropriate business formalities [were] employed, industry customs and practices [were] followed, and . . . compliance with relevant commercial norms," 250 F. Supp. 2d at 811, was overly broad. This Court concludes that the Sixth Circuit, in light of its *AEP dicta*, will likely adopt the Third Circuit's conclusion that the propriety of any particular transaction, except in the most flagrant cases, is properly reserved for a sham in substance analysis, and that the factual sham analysis should be limited simply to the question of whether the transaction in question actually occurred.

This Court deems it prudent to follow the *dictum* laid down by the Sixth Circuit in a case with parallel facts and nearly identical issues. As noted above, the transactions which comprised the partial withdrawals actually occurred and caused real economic consequences. Accordingly, they do not fit within the revised definition of "sham in fact."

It is also pertinent to note that parties to a written agreement may act *inter se* in a manner that departs from the terms of the agreement, to the extent that the performance of the contract is not somehow contrary to law or the interests of some other beneficiary. In the consensual framework that characterizes contractual relationships, the parties are free to interpret their contract in a mutually agreed manner, or excuse performance, or subsequently modify its terms. *See, e.g., Restatement (Second) of Contracts* § 5 cmt. a (1981) ("The terms of a promise or agreement are those expressed in the language of the parties or implied in fact from other conduct. Both language and conduct are to be understood in the light of the circumstances, including course of dealing or usage of trade or course of performance."); *id.* § 201(1) ("Where the parties have attached the same meaning to a promise or agreement or a term thereof, it is interpreted in accordance with that meaning."); *id.* § 202 cmt. g ("Where it is unreasonable to interpret the contract in accordance with the course of performance, the conduct of the parties may be evidence of an agreed modification or of a waiver by one party."); *id.* § 287(1) ("If a party, knowing of an alteration that discharges his duty, manifests assent to the altered terms, his manifestation is equivalent to an acceptance of an offer to substitute those terms."). Michigan law incorporates these concepts. *See, e.g., Michigan Portland Cement Co. v. General Builders Supply Co.*, 240 Mich. 701, 703, 216 N.W. 376 (1927); *American Locomotive Co. v. Gyro Process Co. et al.*, 185 F.2d 316, 319-20 (6th Cir. 1950).

The Court's previous conclusion that the partial withdrawals are were shams in fact therefore was not correct, and the Court vacates that portion of the opinion so holding. This holding renders moot the government's argument relating to the logical consequences that would flow from a determination that the partial withdrawals in plan years four through six were factual shams.

B.

The government also attacks this Court's opinion in two other respects. First, the government contends that the Court has confounded the concept of mortality neutrality and risk transfer, and therefore has erroneously concluded that the potential for realizing mortality gains in the plans was one component that imbued them with economic substance apart from the tax deductions for policy loan interest. Second, the government takes issue with the Court's assessment of the net present value of each of the plans because of a perception on the part of the government that the calculations relied upon do not subtract the effect of the income tax deductions, and therefore fail to evaluate the economic substance of the plans absent the tax benefits. The government contends that the Sixth Circuit wrote to both of these issues in *AEP*, and the Court should *sua sponte* expand the grounds for reconsideration and address these issues in light of the recent appellate decision.

1.

The court of appeals drew a distinction between the terms "mortality neutrality" and "transfer of risk" in *AEP* largely on the basis of its focus on individual policies on one hand, and the operation of the entire plan on the other. Mindful that the core issue was whether the plan in *AEP* had economic substance, the court stated:

> Similar reasoning leads us to reject AEP's argument that because "each individual COLI policy transfers risk and has economic substance," the COLI plan as a whole must have economic substance. Each individual COLI policy did in fact transfer risk and thereby have economic substance, as was the case in *Woodson-Tenent*. Mortality neutrality, however, operated on the plan as a whole, ensuring that whatever transfer of risk occurred at the level of the individual policy ceased to exist for the overall plan . . . . Mortality neutrality and zero net equity operated only at the level of the entire plan.

AEP, 326 F.3d at 742-43. This Court interchanged the terms in its opinion, however no error or analytical flaw resulted since the Court consistently applied the terminology to an assessment of the plans as a whole, not the individual policies, in the manner criticized by the court of appeals in *AEP*. Moreover, "mortality neutrality" is a term the government itself invented for its COLI litigation, and therefore the Court must discount to some extent the government's critique that this Court failed to "properly" use a term that has no basis in actuarial science. *Dow*, 250 F. Supp. 2d at 807 & n.6. More importantly, this distinction is not material to the Court's resolution of this case. Although this Court did focus its analysis with regard to mortality by finding that there was no 100% "true-up" of benefits and costs at the end of each year, it necessarily follows that a plan that is not designed to eliminate every dime of mortality profit (i.e., the potential to receive more in death benefit than the amount expended on the cost of insurance) cannot be "mortality neutral" over the long term either. The presence of risk transfer and the possibility of a mortality profit *on a plan-wide basis* was one of the grounds on which this Court

based its finding that the COLI plans were imbued with economic substance independent of the income tax deductions. Once again, this assessment required an analysis of the plan, not the individual policies, especially in the case of the MetLife plan, which was written on a group policy form. The Court believes that its treatment of the issue of "mortality neutrality" was complete, correct, and consistent with the statements of the court of appeals in *AEP*. There is no need, therefore, to subject this aspect of the case to further litigation by expanded briefing or otherwise.

2.

Nor does the Court find that anything the Sixth Circuit wrote in *AEP* affects the basis on which this Court evaluated the economic viability of the policies. The Sixth Circuit did emphasize that the economic viability of a transaction (as measured in net present value, or NPV) should be evaluated on a "pre-tax" basis, meaning that the effect of the tax deductions must be subtracted. But the deduction the Sixth Circuit sought to exclude from the analysis was for the loan interest, not the tax benefit from the deferred inside build-up itself. *AEP*, 326 F.3d at 743-44. "Life insurance is tax-favored, and a company may utilize the tax advantages of a COLI plan so long as the plan has real economic consequences." *Id.* at 744.

Here, the government's urging that a pure "pre-tax" method be used ignores one of the legitimate, tax-advantaged purposes of purchasing life insurance in the first place, which is to secure tax-free inside build-up. The testimony of Dow's experts, which the Court found to be both credible and reliable, *see Dow*, 250 F. Supp. 2d at 806-07, demonstrated that the best compromise between a pure "pre-tax" evaluation – which ignores the tax-deferred purpose of the transaction – and a pure "post-tax" analysis – which

"would swallow the sham analysis entirely," *AEP*, 326 F.3d at 743 – is to use a pre-tax net present value analysis with a lowered discount factor. *Dow*, 250 F. Supp. 2d at 806-07. As the Third Circuit made clear in *CM Holdings*:

> The point of the analysis is to remove from consideration the challenged tax deduction, and evaluate the transaction on its merits, to see if it makes sense economically or is mere tax arbitrage. Courts use "pre-tax" as shorthand for this, but *they do not imply that the court must imagine a world without taxes*, and evaluate the transaction accordingly. Instead, they focus on the abuse of the deductions claimed: "[w]here a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes." *[United States v.]Wexler,* [31 F.3d 117,] 122 [3d Cir. 1994]. Choosing a tax-favored investment vehicle is fine, but engaging in an empty transaction that shuffles payments for the sole purpose of generating a deduction is not.

301 F.3d at 105 (citations omitted) (emphasis added), *quoted with approval by AEP*, 326 F.3d at 743-44. Similarly, Dow was not required at the time the policies were to purchased to pretend that it lived in a tax-free environment. Rather, it was required to determine whether the deductions would be enhancing the benefit of an already economically viable set of transactions. None of the methods for evaluating the net present value of Dow's policies could pretend to predict exact results, and Dow's decision to use the method it did for evaluating the viability of the policies was not unreasonable under the circumstances, as this Court concluded in its original opinion. *See* 250 F. Supp. 2d at 806-07, 809-10.

Likewise, the Court's analysis of the "pre-tax" viability of the COLI plans accounted for the effect of the tax deductions and, consistent with the court of appeals' pronouncement in *AEP*, evaluated the projected economic results absent the tax deductions, in concluding that both plans offered substantial, non-tax benefits that would be realized by Dow over the life of the plans. *See Dow*, 250 F. Supp. 2d at 807, 810-11.

As this Court concluded in its opinion, the policies in this case were not "empty transactions[s]" entered into "for the sole purpose of generating a deduction," 301 F.3d at 105, and the COLI policies were therefore not an economic sham. The Court sees no necessity to revisit this issue in light of *AEP*.

III.

Although statements by the Sixth Circuit in *AEP* have propelled the Court to reassess its treatment of the partial withdrawal features of the COLI plans under a sham-in-fact analysis, the Court declines to further modify its opinion in the manner urged by the government, or expand the post-judgment briefing in this case.

Accordingly, it is **ORDERED** that the defendant's motion to amend the Court's judgment pursuant to Rule 59(e) of the Federal Rules of Civil Procedure and make additional factual findings in support of this amendment pursuant to Rule 52(b) [dkt #96] is **GRANTED IN PART AND DENIED IN PART.**

It is further **ORDERED** that the Court's opinion dated March 31, 2003 is **MODIFIED** as reflected herein. The Court's judgment remains the same.

It is further **ORDERED** that the government's request to establish a briefing schedule to determine the effect of an intervening Sixth Circuit decision on this Court's judgment [dkt #101] is **DENIED**.

It is further **ORDERED** that the government's motions to file an expanded reply brief [dkt #s 98, 101] are **GRANTED**.

It is further **ORDERED** that the plaintiff's request, accompanied by a stipulation of the parties, to file a response out-of-time [dkt #103] is **GRANTED**.

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 03-2360

THE DOW CHEMICAL COMPANY,
Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

ORDER DENYING PETITION FOR REHEARING WITH SUGGESTION FOR REHEARING EN BANC

FILED MAY 24, 2006
BY LEONARD GREEN, CLERK

BEFORE: RYAN, MOORE, AND COOK, CIRCUIT JUDGES.

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied. Judge Ryan would grant rehearing for the reasons stated in his dissent.

ENTERED BY ORDER OF THE COURT

/s/ Leonard Green
Leonard Green, Clerk

APPENDIX E

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN
NORTHERN DIVISION

No. 00-10331-BC

THE DOW CHEMICAL COMPANY
AND SUBSIDIARIES,
Plaintiff,

v.

UNITED STATES OF AMERICA,
Defendant.

JUNE 9, 2006

HONARABLE DAVID M. LAWSON

[Proof of Service]
[The undersigned certifies that a copy]
[of the foregoing order was served upon]
[each attorney or party of record herein]
[by electronic means or first class U.S.]
[mail on June 9, 2006.]
[s/Tracy A. Jacobs]
[TRACY A. JACOBS]

AMENDED JUDGMENT

Pursuant to the opinion and order of the United States Court of Appeals for the Sixth Circuit filed January 23, 2006, and confirmed by mandate filed June 1, 2006,

It is **ORDERED AND ADJUDGED** that the plaintiff shall take nothing on its complaint and the complaint is dismissed with prejudice.

s/ David M. Lawson
DAVID M. LAWSON
United States District Judge

Dated: June 9, 2006

APPENDIX F

Internal Revenue Code of 1986 (26 U.S.C. (1989 ed.))

* * *

§ 162. Trade or business expenses

(a) In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * *

§ 163. Interest

(a) General rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * *

§ 264. Certain amounts paid in connection with insurance contracts

(a) General rule.—No deduction shall be allowed for—

(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

(3) Except as provided in subsection (c), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise).

(4) Any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual who—

(A) is an officer or employee of, or

(B) is financially interested in,

any trade or business carried on by the taxpayer to the extent that the aggregate amount of such indebtedness with respect to policies covering such individual exceeds $50,000.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954. Paragraph (3) shall apply only in respect of contracts purchased after August 6, 1963.

Paragraph (4) shall apply with respect to contracts purchased after June 20, 1986.

* * *

(c) Exceptions.—Subsection (a)(3) shall not apply to any amount paid or accrued by a person during a taxable year on indebtedness incurred or continued as part of a plan referred to in subsection (a)(3)—

(1) if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness,

(2) if the total of the amounts paid or accrued by such person during such taxable year for which (without regard to this paragraph) no deduction would be allowable by reason of subsection (a)(3) does not exceed $100,

(3) if such amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in his financial obligations, or

(4) if such indebtedness was incurred in connection with his trade or business.

For purposes of applying paragraph (1), if there is a substantial increase in the premiums on a contract, a new 7-year period described in such paragraph with respect to such contract shall commence on the date the first such increased premium is paid.

APPENDIX G

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 03-2360

THE DOW CHEMICAL COMPANY
AND SUBSIDIARIES,
Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

ON APPEAL FROM THE JUDGMENT OF THE
UNITED STATES DISTRICT COURT FOR THE
EASTERN DISTRICT OF MICHIGAN

FINAL BRIEF FOR APPELLEE

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* * *

ARGUMENT

Standard of Review

Dow agrees with the government (at 33) that legal standards are reviewed de novo and factual findings under the "clearly erroneous" test. Although Dow also accepts, for purposes of this appeal, that the ultimate conclusion on economic substance is reviewed de novo, this is only because, under *AEP*, this ultimate determination follows directly from affirmance or reversal of the trial court's finding on Dow's capped-loan intent or, alternatively, its ruling on potential mortality gain. *See* Point I below.[15]

* * *

---

[15] *AEP*, 326 F.3d at 741-42, stated that the economic substance determination is subject to de novo review. But this was dictum because the panel would have reached the same result under a "clearly erroneous" standard. Moreover, the panel incorrectly failed to treat *Ratliff v. Comm'r*, 865 F.2d 97, 98-99 (6th Cir. 1989), as binding precedent. *Ratliff* stated that a judgment on economic substance is reviewable under the "clearly erroneous" test because it is "'ultimately a finding of fact,'" and expressly adopted *Yosha v. Comm'r*, 861 F.2d 494, 499 (7th Cir. 1988), which held that "[t]he question whether a particular transaction has economic substance ... is governed by the clearly erroneous standard." *See also Smith v. Comm'r*, 937 F.2d 1089, 1096 (6th Cir. 1991) (reversing Tax Court's sham determination because it left the court 'with the definite and firm conviction that a mistake has been committed'"). *Frank Lyon Co.v. United States*, 435 U.S. 561, n.16 (1978), cited by *AEP*, contains a one-sentence dictum implying that the standard of review of the characterization of a transaction for tax purposes is de novo. But the case, which pre-dates *Ratliff*, *Yosha*, and *Smith*, involved the legal consequences of established facts, not the resolution of disputed facts under an agreed-on legal standard.

APPENDIX H

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 03-2360

THE DOW CHEMICAL COMPANY
AND SUBSIDIARIES,
Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

ON APPEAL FROM THE JUDGMENT OF THE
UNITED STATES DISTRICT COURT FOR THE
EASTERN DISTRICT OF MICHIGAN

APPELLANT'S OPPOSITION TO APPELLEE'S PETITION FOR
REHEARING WITH SUGGESTION FOR REHEARING EN BANC

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* * *

As did the Supreme Court in *Knetsch,* the majority correctly determined that, as a matter of law, in considering the economic effect of the transaction as a whole it could not take into account the taxpayer's purported intent to make massive future investments that were totally inconsistent with the taxpayer's past conduct.

* * *

APPENDIX I

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April 17, 2006

VIA FEDEX

Leonard Green, Esq.
Clerk, U.S. Court of Appeals for the Sixth Circuit
100 East 5th Street
Potter Stewart U.S. Courthouse
Cincinnati, Ohio 45202-3988

Re: *The Dow Chemical Co. v. United States*, 6th Cir. No. 03-2360, Petition for Rehearing with Suggestion for Rehearing En Banc pending

Dear Mr. Green:

The Dow Chemical Company ("Dow") respectfully submits this letter (with 25 copies) pursuant to Federal Appellate Rule 28(j) to bring *Indmar Products Co. v. Comm'r*, 6th Cir. No. 05-1573 (April 14, 2006) (copies enclosed), to the panel and en banc Court's attention in the above appeal.

In reviewing the characterization of a transaction for tax purposes, the majority opinion in *Indmar* by Judge McKeague applied the "clearly erroneous" standard because that was the correct standard for debt-equity issues under this Circuit's precedents. The same standard should apply to the economic sham issues in *Dow* since both cases turn on economic substance. In any event, the *Dow* majority erred by applying the "de novo" standard in fashioning novel legal rulings because this Court's earliest precedent had adopted the "clearly erroneous" test for economic sham issues. *See* Dow Rehearing Petition at 14; Dow opening merits brief at 39 n.15.[1] *See also United States v. Patterson,* 2005 U.S. App. LEXIS 18944, at **16-17 (6th Cir. 2005) (earliest decision controls unless overruled by en banc or Supreme Court decision).

Judge Rogers concurred in *Indmar,* explaining that the "clearly erroneous" and "de novo" standards apply to the extent that the appeal turns on factual and legal disputes, respectively. The *Dow* majority also erred under this analysis. Judge Lawson's ultimate legal conclusion on economic substance rested (alternatively) on his finding that Dow could be counted on to create net equity by capping loans and paying policy costs in cash. The governing legal standard ("practicable [non-tax] economic effects") was undisputed. The sole pertinent issue was one of fact – whether Dow actually intended to generate net equity – which is subject to the "clearly erroneous" standard.

Judge Moore dissented in *Indmar* on the ground that the majority had not paid sufficient deference to the trial

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[1] Contrary to the *Dow* Slip op. at 5 n.8, Dow argued for "clearly erroneous" review. It accepted "de novo" review only on the condition that no issue existed about relevant legal principles – a condition the majority vitiated by novel legal rulings.

court under the "clearly erroneous" standard. That position also supports Dow's rehearing petition.

Sincerely,

/s/ Gerald Goldman

Gerald Goldman
Of Counsel

Enclosures

cc (by electronic mail and U. S. mail with copies of *Indmar*):

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APPENDIX J

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Via FedEx

April 19, 2006
[Received April 20, 2006 by FedEx]

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Re: *The Dow Chemical Co. & Subsidiaries v. United States of America* (6th Cir. No. 03-2360)

Dear Mr. Green:

We respond to appellee's letter informing the Court of *Indmar Products Co., Inc. v. Commissioner,* 6th Cir. No. 05-1573. In *Indmar,* a divided panel of this Court reversed

the Tax Court's determination that advances made by stockholders to a closely-held corporation were equity, as opposed to debt. In the first of three opinions issued by the panel, Judge McKeague concluded that this Court must follow its earlier decisions holding that the debt/equity question is one of fact reviewed for clear error (Op. 6) and that the Tax Court should be reversed because it committed clear error in finding that the advances were loans (Op. 11). Judge Rogers concurred, but wrote separately "to explain why the legal, non-factual components of the tax court's analysis are properly examined without deference to the tax court, notwithstanding the overall 'clearly erroneous' standard that our court has stated to be applicable to the determination of the [debt/equity question]." (Op. 12.) Judge Moore dissented because she believed that the Tax Court's conclusion that the advances were equity was not clearly erroneous. (Op. 16.)

Indmar is consistent with the Court's decision in the instant case and provides no support for Dow's rehearing petition. Here, the Court followed its prior precedent, *American Electric Power v. United States,* 326 F.3d 737, 740 (6th Cir. 2003), *cert denied,* 540 U.S. 1104 (2004), holding that the ultimate question of whether a transaction is an economic sham is a legal one. It also examined the teachings of the Supreme Court in *Knetsch v. United States,* 364 U.S. 361 (1960), and concluded that, as a matter of law, highly contingent cash infusions that purportedly would be made in distant years and that represented a significant departure from prior conduct were not to be taken account in the sham analysis. Because the district court had erred in taking such purported future cash infusions into account, the Court did not need to address the Government's argument that the district court's findings were clearly erroneous.

Sincerely,

/s/ Robert W. Metzler
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APPENDIX K

Model Regulation Service—January 1994

GUIDELINES ON CORPORATE OWNED LIFE INSURANCE

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Corporate Owned Life Insurance (COLI) is life insurance a corporate employer buys covering one or more employees. With COLI, the employer is generally the applicant, owner, premium payer and beneficiary of the policy. COLI can be acquired on an individual or group basis and can take many forms. For example, it can be used to indemnify the employer for the loss of earnings or costs of replacing a key employee who becomes disabled or dies, or to finance the cost of a stock redemption agreement or a deferred compensation plan. COLI has also increasingly been used as a financing vehicle for broad-based welfare benefit plans, such as health benefit plans.

This relatively new application of the principals of corporate owned life insurance to retiree health benefits is largely attributable to the promulgation of Statement 106 by the Financial Accounting Standards Board (FASB). Under FASB 106, post-retirement benefits, including retiree health benefits, are required to be accrued as they are earned over the working lifetime of the employee, rather than as they are paid after retirement. Unfunded accrued benefits create a growing balance sheet liability. COLI or a variation thereof, Trust Owned Life Insurance (TOLI), where the insurance is purchased by a trust, typically a VEBA trust established under Section 501(c)(9) IRC, create a balance sheet asset which the employer can use to finance the cost of the benefit.

COLI and TOLI are attractive methods of financing liabilities such as an employer's obligations under a retiree health benefit plan. When for example, retiree health benefits are provided through an insured health benefit plan, the policy's cash values can be used to finance the after-tax cost of the health insurance premiums for the retired employees. When an insured retired employee dies, the policy death benefit allows the company to recover part or all of the costs of the plan. The policy values and death benefit also represent a source of funds which can be used to pay premiums for other employees who are covered under the plan.

When an employer provides health benefits to retired employees on a self-insured basis, the cash values and death benefits of the coverage are used to finance the coverage. Moreover, contributions to the VEBA Trust may, within well defined limits, be deductible to the employer.

Because of COLI's and TOLI's attractiveness in financing an employer's obligation under a plan established to provide broad-based welfare benefits to retirees, there has been increased interest in the use of COLI and TOLI for this purpose. There has also been increased interest in assuring that COLI and TOLI arrangements satisfy insurable interest requirements.

Business entities traditionally have been found to have insurable interests in the lives of their officers, managers and key employees. This is because the business may reasonably expect to benefit from the continuance of their lives or to suffer a loss if these individuals die. Many states have also recognized an insurable interest in the lives of non-key employees, particularly in the context of financing broad-based welfare benefit plans.

Some states have enacted laws that either specifically recognize an insurable interests in a COLI-TOLI arrangement, including those whose purpose is the financing of broad based welfare plan arrangements. Other states have found such insurable interests in their common law; in interpretations of existing statutes and case law without specific COLI-TOLI enabling language.

Citations to state statutes relating to insurable interests of employers in their employees can be obtained by contacting the Legal Department of the NAIC.

States considering a legislative response to insurable interest concerns regarding employers and their employees should consider the following elements for inclusion in their law:

1. The law should recognize that employers have a lawful and substantial economic interest in the lives of key employees and in other employees who have a reasonable expectation of benefiting from an employee welfare benefit plan.

2. Employers should be required to notify eligible employees of their proposed participation in the plan and the employees should be given an opportunity to refuse to participate.

3. For non-key or non-managerial employees, the amount of coverage should be reasonably related to the benefits provided to the employees.

4. With respect to employer provided pension and welfare benefit plans, the life insurance coverage purchased to finance the plans should only be allowed on the lives of those employees and retirees

who, at the time their lives are first insured under the plan, would be eligible to participate in the plan.

Legislative History (all references are to the Proceedings of the NAIC).

1993 Proc. I 17,10, 780, 782-783 (adopted).

APPENDIX L

OCC 2000-23
OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: Bank Purchases of Life Insurance
Description: Guidelines for National Banks
Date: July 20, 2000

TO: Chief Executive Officers of All National Banks, Department and Division Heads, and All Examining Personnel

PURPOSE

This bulletin provides general guidelines for national banks to help ensure that bank purchases of life insurance are consistent with safe and sound banking practices. It replaces Bulletin 96-51, dated September 20, 1996, which is hereby rescinded.

BACKGROUND

Corporate-owned life insurance (COLI) includes all life insurance that a corporation, such as a bank, purchases and owns or has a beneficial interest in. Life insurance is a financial instrument which serves many necessary and useful business purposes. However, as with most financial instruments, COLI can be complicated and is not without risk. Furthermore, COLI transactions are unique and represent activities which differ greatly from the main business activity of most corporations. Some national banks

have purchased COLI without fully understanding the transactions and the associated risks.

This bulletin is designed to help national banks make informed decisions consistent with safe and sound banking practices. Bankers should complete a thorough analysis before purchasing COLI. This bulletin sets forth supervisory policy, including minimum standards for pre-purchase analyses, applicable to the purchase of COLI by national banks. The bulletin also includes discussions of the most common uses of COLI and the associated risks.

LEGAL AUTHORITY

The authority for national banks to purchase and hold life insurance is found in 12 USC 24(Seventh), which provides that national banks may exercise "all such incidental powers as shall be necessary to carry on the business of banking." Purchases of life insurance that the OCC has found to be incidental to banking include key-person insurance, insurance on borrowers, insurance purchased in connection with employee compensation and benefit plans, and insurance taken as security for loans.[1] The OCC may approve other uses for bank-owned life insurance on a case-by-case basis. However, a purchase of life insurance must address a legitimate need of the bank for insurance. Life-insurance may not be purchased to generate funds for the bank's normal operating expenses, for speculation, or for the primary purpose of providing estate planning benefits for bank insiders unless it is part of a reasonable compensation package. In addition, the purchase of life insurance is subject to supervisory considerations, and life insurance

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1 The appendix contains a discussion of each of these four uses of COLI.

holdings must be consistent with safe and sound banking practices.

SUPERVISORY POLICY

The purchase of permanent life insurance (permanent insurance) policies subjects the policyholder to several risks. The cash surrender value (CSV) of most life insurance products is subject to credit risk.[2] Usually, the CSV is a long-term, unsecured, nonamortizing obligation of the insurance company. The CSV is also subject to several other risks, such as transaction risk, interest rate risk, liquidity risk, compliance risk, and price risk.

National banks holding life insurance in a manner inconsistent with safe and sound banking practices may be subject to supervisory action. This bulletin outlines supervisory considerations to be used in making this assessment. Supervisory action may include, but is not limited to, partial surrender or divestiture of affected policies.

Pre-purchase Analysis:

The safe and sound use of bank-owned life insurance depends on effective senior management and board oversight. Regardless of the bank's financial capacity and risk profile, the board must understand the role bank-owned life insurance plays in the overall business strategies of the bank.

The board's role in analyzing and overseeing bank-owned life insurance should be commensurate with the size,

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[2] Permanent insurance and cash surrender value are described in the appendix on page 1.

complexity, and risk inherent in the transaction. Although the board may delegate decision-making authority related to bank purchases of life insurance to management, the board remains responsible for ensuring that purchases of life insurance are consistent with safe and sound banking practices.

The objective of the pre-purchase analysis is to help ensure that the bank understands the risks, rewards, and unique characteristics of COLI. As such, each purchase or assumption of a beneficial interest in COLI should be preceded by a thorough pre-purchase analysis. At a minimum, the pre-purchase analysis should consider the following standards.

I. *Determination of the Need for Insurance*

The bank should determine the need for insurance by identifying the specific risk of loss or obligation to be insured against. The existence of a risk of loss or an obligation does not necessarily mean that a national bank can purchase or hold an interest in life insurance. For example, a national bank may not purchase life insurance on a borrower as a mechanism for effecting a recovery on obligations that have been charged-off, or are expected to be charged-off for reasons other than the borrower's death.[3] Also, a national bank should surrender or otherwise dispose of permanent life insurance acquired through debts previously contracted (DPC) within a short time frame, generally 90 days, of obtaining control of the policy.[4]

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[3] The purchase of life insurance on borrowers whose obligations have been charged-off, or are expected to be charged-off, is further discussed in the appendix on pages 6-7.

[4] Life insurance acquired through DPC is further discussed in the appendix on page 7.

Additionally, the purchase of insurance to indemnify a national bank against a specific risk does not relieve a national bank from other responsibilities related to managing that risk. For example, a national bank may purchase life insurance to indemnify itself from the loss of a "key-person." However, "key-person" life insurance should not be used in place of, nor does it diminish the need for, adequate management or "key-person" succession planning.[5]

II. *Quantification of the Amount of Insurance Needed*

The bank should estimate the size of the obligation or the risk of loss and ensure that the amount of insurance purchased is not excessive in relation to the estimate. For such estimates, national banks may include the cost of insurance and the time value of money in determining the amount of insurance needed. The estimate of the amount of insurance needed should be based on reasonable financial and actuarial assumptions. In situations where a national bank purchases life insurance on a group of employees or a homogenous group of borrowers, it can estimate the size of the obligation or the risk of loss for the group on an aggregate basis and compare that to the aggregate amount of insurance purchased.

Purchasing or holding excessive permanent insurance may be an unsafe and unsound practice if it subjects the bank to unwarranted risks. Bank-owned life insurance subjects the bank to several risks which may be significant. The risks are explained in the "Risks Associated With COLI" section of this bulletin.

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[5] The relationship between "key-person" insurance and management succession planning is discussed in the appendix on pages 4-5.

III. *Vendor Selection*

The vast majority of COLI purchases are made through vendors, either brokers/consultants or agents. Most corporations have used brokers/consultants. However, some corporations have purchased COLI through agents who work for specific insurance companies. It is also possible to purchase COLI directly from insurance carriers without using a vendor.

The role of the vendor, if any, depends on the type of vendor selected. For example, the vendor may be an agent of a specific insurance company who serves as the bank's primary contact with the insurance company, explains the company's various products, and helps the bank in making product selection. Or, the vendor may be an independent broker who has established working relationships with many insurance companies. In addition to being the bank's primary contact with the insurance company, the broker will work with the bank in selecting a carrier and in designing, negotiating, and administering/servicing the COLI.

The bank does not have to use a vendor. In deciding whether or not to use a vendor or what type of vendor to use, the bank should consider its knowledge of COLI, the amount of resources it can and is willing to spend servicing/administering the COLI, and the benefits a vendor may provide. Depending on the role of the vendor, the vendor's services can be extensive and critical to successful implementation and operation of a COLI plan. If the bank uses a vendor, it should make appropriate inquiries to satisfy itself regarding the vendor's ability to honor its commitments, which may be long term. In assessing the vendor's ability to honor its commitments, the bank should typically review the vendor's services, general reputation, experience, and financial capacity. The nature and

thoroughness of the review should be determined by the size and complexity of the potential COLI purchase.

IV. *Carrier Selection*

COLI plans are typically of long duration and may represent significant risks for the bank. Therefore, carrier selection is one of the most critical steps in a COLI purchase. The bank should review the product design, pricing, and administrative services of the carrier(s) and compare them with the bank's needs. In addition, the bank should also review the carrier's ratings, general reputation, experience in the market place, and past performance. A broker/consultant, if used, may assist the bank in this regard.

Furthermore, before purchasing life insurance, the bank should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending. A more complete discussion of the credit analysis is included in the "Credit Risk" section of this bulletin.

V. *Review the Characteristics of the Available Insurance Products*

There are a few basic types of life insurance products in the marketplace. However, these products can be combined and modified in many different ways. The resulting final product can be quite complex. The bank should review the characteristics of the various insurance products available. It should select the product or products with characteristics that match the institution's objectives and needs. To do this, the bank should thoroughly analyze and understand the products being considered.

When purchasing insurance on "key-persons" and individual borrowers, the bank should consider whether the bank's need for the insurance will be eliminated before the insured individual dies. In such cases, term or declining term insurance may be the most appropriate form of life insurance.[6]

VI. *Analyze the Benefits of COLI*

The bank should analyze the benefits of COLI purchases being considered. The analysis should include an assessment of how the purchase will accomplish the objective specified in "I. Determination of the Need for Insurance." It should also include an analysis of the anticipated performance of the insurance. A more complete discussion of this analysis is included in the "Transaction Risk" section of this bulletin.

VII. *Determine the Reasonableness of Compensation Provided to the Insured Employee if the Insurance Results in Additional Compensation*

Split-dollar insurance arrangements[7] typically provide additional compensation and/or other benefits to the employee. Before a national bank enters into a split-dollar arrangement, it should identify and quantify the compensation objective, and ensure that the arrangement is consistent with the stated objective. Also, the bank should combine the compensation provided by the split-dollar arrangement with all other compensation to ensure that total compensation is not excessive. Excessive compensation is prohibited as an unsafe and unsound practice. Guidelines for

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[6] Key-person" insurance and life insurance on borrowers are discussed further in the appendix on pages 4-7.

[7] Split-dollar insurance arrangements are defined and discussed in the appendix on pages 3-4.

determining excessive compensation can be found in Appendix A to 12 CFR Part 30 - Interagency Guidelines Establishing Standards for Safety and Soundness.

VIII. *Analyze the Associated Risks and the Bank's Ability to Monitor and Respond to those Risks*

Ownership of or beneficial interests in COLI may subject a national bank to several risks. These risks include: transaction, credit, interest rate, liquidity, compliance, and price. A bank's pre-purchase analysis should include a thorough evaluation of these risks. An explanation of each risk is included in the "Risks Associated With COLI" section of this bulletin.

Furthermore, the pre-purchase analysis should allow a national bank to determine whether the transaction is consistent with safe and sound banking practices. In making this determination, a national bank should consider, among other things:

- The complexity of the transaction.
- The size of the transaction relative to the bank's capital.
- The diversification of the credit risk.
- The financial capacity of the bank.
- The financial capacity of the insurance carrier(s).
- The bank's ability to identify, measure, monitor, and control the associated risks.

In assessing the size of the transaction, a national bank should consider the CSV relative to its capital levels at the time of purchase. The bank should also consider projected increases in the CSV and projected changes in capital levels for the duration of the contract.

Consistent with prudent risk management practices, a national bank should establish internal quantitative guidelines. These guidelines generally limit the aggregate CSV of policies from any one insurance company and the aggregate CSV of policies from all insurance companies. Among other things, a bank should consider the legal lending limits (12 CFR Part 32) and concentration of credit guidelines (OCC Bulletin 95-7, dated February 9, 1995) when establishing the respective limits.

IX. *Evaluate Alternatives*

Some COLI purchases involve indemnifying the bank against a specific risk. For example, COLI is sometimes purchased to indemnify the bank against the potential for loss arising from the untimely death of a "key-person." As an alternative to purchasing COLI, a bank may choose to self-insure against this risk. Other COLI purchases are used to recover costs or provide for employee benefits. In these cases, a bank may choose to generate the necessary funds through investments instead of by purchasing insurance. Regardless of the purpose of COLI, a complete pre-purchase analysis will include an analysis of the alternatives.

X. *Document Decision*

The primary objective of this bulletin is to provide guidelines that will help national banks make informed decisions consistent with safe and sound banking practices. In doing so, national banks generally should consider the pre-purchase analysis just described. A national bank should maintain documentation adequate to show that the bank made an informed decision. The bank should continue to monitor that decision based on the standards set forth in this bulletin.

RISKS ASSOCIATED WITH COLI

For purposes of the OCC's discussion of risk, examiners assess banking risk relative to its impact on capital and earnings. From a supervisory perspective, risk is the potential that events, expected or unanticipated, may have an adverse impact on the bank's capital or earnings. The OCC has defined nine categories of risk for bank supervision purposes. These risks are: *Credit, Interest Rate, Liquidity, Price, Foreign Exchange, Transaction, Compliance, Strategic, and Reputation.* These categories are not mutually exclusive; any product or service may expose the bank to multiple risks. For analysis and discussion purposes, however, the OCC identifies and assesses the risks separately.

The applicable risks associated with COLI are: *Transaction, Credit, Interest Rate, Liquidity, Compliance, and Price.* The definitions of these six risks are summarized below. For complete definitions, see the "Bank Supervision Process" booklet of the *Comptroller's Handbook.* An analysis of how each of these risks impact the decision to purchase and hold COLI is set forth in the following paragraphs.

Transaction Risk

Transaction risk is the risk to earnings or capital arising from problems with service or product delivery. The degree of transaction risk associated with COLI is a function of a bank not fully understanding or properly implementing a transaction. In addition to following the other guidelines included in this bulletin, national banks should take two additional steps to help reduce transaction risk. Bank management should have a thorough understanding of how the insurance product works and the variables that dictate the product's performance. The variables most likely to affect

product performance are the policy's interest crediting rate,[8] mortality cost,[9] and other expense charges. Typically, the most significant variable is the interest crediting rate, followed by the mortality cost. Therefore, before purchasing COLI, a national bank should analyze projected policy values (CSV and death benefits) from multiple illustrations provided by the carrier. Banks should consider using different interest crediting rates and mortality costs assumptions for each illustration.

Bank management should also understand and analyze how COLI will affect the bank's financial condition. Given the anticipated performance of the insurance, management should analyze the effect on the bank's earnings, capital, and liquidity. Management should also consider the impact on the bank's earnings and capital should the bank, for any reason, surrender the insurance before maturity at the death of the insured.

Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise fail to perform as agreed. All life insurance policyholders are exposed to credit risk. The

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[8] The interest crediting rate refers to the gross yield on the investment in the insurance policy, *i.e.*, the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs that are periodically charged against the policy's cash value. Insurance companies frequently disclose a current interest crediting rate and a guaranteed minimum interest crediting rate. The guaranteed rate may be less than the current rate. As a result, the potential exists for future declines in the interest crediting rate.

[9] Mortality cost represents the cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk.

credit quality of the insurance company and duration of the contract are key variables. With term insurance, credit risk arises from the insurance carrier's contractual obligation to pay death benefits upon the death of the insured. Credit risk is primarily a function of the insurance carrier's ability (financial condition) and willingness to pay death benefits as promised. Credit risk may be reduced by the support provided by state insurance guaranty associations or funds. A bank's credit exposure through the ownership of term life insurance is not reflected on the bank's balance sheet.

With permanent insurance, credit risk arises from the insurance carrier's obligation to pay death benefits upon death of the insured and from its obligation to return the CSV to the policyholder upon request. The risk is similar to that with term insurance, but there are a few differences. With most permanent insurance COLI plans, the expected time frame for collection of death proceeds is extremely long term. Additionally, the CSV is an unsecured, long-term, and nonamortizing obligation of the insurance carrier. The risk inherent in the insurance company's failure to return the CSV value is, reflected on the bank's balance sheet.

Before purchasing life insurance, bank management should evaluate the financial condition of the insurance company and continue to monitor its condition on an ongoing basis. In addition to reviewing the insurance carrier's ratings, the bank should conduct an independent financial analysis consistent with safe and sound banking practices for commercial lending. As with lending, the depth and frequency of the analysis should be a function of the relative size and complexity of the transaction.

Interest Rate Risk

Interest rate risk is the risk to earnings or capital arising from movements in interest rates. General account[10] products expose the policyholder to interest rate risk. The interest rate risk of these products is primarily a function of the policy's interest crediting rate. Interest crediting rates are established by the insurance carrier. Over the long term, interest crediting rates are primarily a function of the carrier's investment portfolio performance. The policy's CSV is negatively affected (grows at a slower rate) by a declining interest crediting rate. Since a bank's investment in permanent insurance is recorded at the policy's CSV, the bank's earnings decline as the policy's interest crediting rate declines.

Due to the interest rate risk inherent in this product, it is particularly important that management fully understand the risk before purchasing the policy. Before purchasing permanent insurance, bank management should:

- Review the policy's past performance over various business cycles.
- Analyze projected policy values (CSV and death benefits).
- Consider having the carrier use a different interest crediting rate for each set of policy projections.

Variable or separate account[11] products may also expose the bank to interest rate risk depending on the types of assets held in the separate account. For example, if the separate

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10 General account products are defined in the appendix on page 2.

11 Variable or separate account products are defined in the appendix on page 2.

account assets consist solely of Treasury securities, the bank is exposed to interest rate risk in the same way as holding Treasury securities directly in its investment portfolio. However, because the bank does not control the separate account assets, it is more difficult for the bank to control this risk. Therefore, before purchasing a separate account product, bank management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent within the separate account and ensure that the risk is appropriate for the bank. Also, the bank should establish monitoring and reporting systems that will enable the bank to monitor and respond to price fluctuations.

Liquidity Risk

Liquidity risk is the risk to earnings or capital arising from a bank's inability to meet its obligations when they come due, without incurring unacceptable losses. Usually, life insurance policies are not marketable and are illiquid. A secondary market for life insurance does not exist. Although the CSV of policies can be accessed quickly, it typically involves substantial loss. To access the CSV, the bank must withdraw from or borrow against the policy. This may subject the bank to surrender charges, taxes on the gain, and a tax penalty. In addition, the policyholder generally does not receive any cash flow until the death benefit is paid. The lack of liquidity in the product is more significant given that banks normally purchase life insurance policies through a conversion of a liquid asset (cash or marketable securities).

Before purchasing permanent insurance, management should recognize the illiquid nature of the product and ensure the bank has the long-term financial flexibility to hold this asset in accordance with its expected use. The inability of a bank

to hold the life insurance until maturity (collection of death benefits) may compromise the success of the COLI plan.

Compliance Risk

Compliance risk is the risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, or ethical standards. Failure to comply with applicable laws, rules, regulations, and prescribed practices (including this bulletin) could compromise the success of a COLI program and result in significant losses for the bank as a result of fines, penalties, or loss of tax benefits. Because tax benefits are critical to the success of most COLI plans, management of a national bank should exercise caution to ensure that its plans comply with all applicable tax laws. In addition, bank management should ensure compliance with other applicable legal and regulatory standards. Other common legal and regulatory considerations include compliance with state insurable interest laws, the Employee Retirement Income Security Act of 1974 (ERISA), sections 23A and 23B of the Federal Reserve Act, 12 CFR Part 215 (Regulation O), and Appendix A to 12 CFR Part 30 - Interagency Guidelines Establishing Standards for Safety and Soundness. Due to the significance of the compliance risk, a national bank may want to seek the advice of qualified counsel.

Price Risk

Price risk is the risk to earnings or capital arising from changes in the value of portfolios of financial instruments. Typically, the policyholder of separate account products assumes all price risk associated with the investments within the separate account. Usually, neither the CSV nor the interest crediting rate on separate account products is guaranteed by the carrier. The amount of price risk is

dependent upon the type of assets held within the separate account.

Because the bank does not control the separate account assets, it is more difficult for the bank to control the price risk. Therefore, before purchasing a separate account life insurance product, bank management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent in the separate account and ensure that the risk is appropriate for the bank. Also, bank management should establish monitoring and reporting systems that will enable them to monitor and respond to price fluctuations.

Banks may purchase separate account insurance products that hold equity securities for the purpose of hedging their obligations under employee compensation and benefit plans.[12] This lessens the effect of price risk on the bank's financial statements because changes in the amount of the bank's liability will be hedged by changes in the value of the separate account assets. An example of such a relationship would be where the amount of the bank's deferred compensation obligation is measured by the value of a stock market index, and the separate account contains a stock mutual fund that mirrors the performance of that index. If the insurance cannot be characterized as an effective hedging transaction, the presence of equity securities in a separate account is impermissible.

In addition to the general considerations discussed above, which are applicable to any separate account product, further

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12 An economic hedge exists when changes in the value of the liability or other risk exposure being hedged are offset by counterbalancing changes in the value of the hedging instrument.

analysis should be performed when purchasing a separate account product involving equity securities. At a minimum, national banks should:

1. Analyze the bank liability being hedged (*e.g.*, deferred compensation) and the equity securities to be held as a hedge in the separate account. Such an analysis usually documents the correlation between the liability and the equity securities, expected returns for the securities (including standard deviation of returns), and current and projected asset and liability balances.

2. Determine a target hedge effectiveness ratio and establish a method for measuring hedge effectiveness. Establish a process for altering the program if hedge effectiveness drops below acceptable levels. Consideration should be given to the potential costs of program changes.

3. Establish a process for analyzing and reporting the effect of the hedge on the bank's income statement and capital ratios. Such an analysis usually shows results both with and without the hedging transaction.

ACCOUNTING CONSIDERATIONS

National banks should follow generally accepted accounting principles (GAAP) for financial reporting and Call Report purposes. Financial Accounting Standards Board (FASB) Technical Bulletin 85-4, "Accounting for Financial Purchases of Life Insurance" (TB 85-4) discusses how to account for investments in life insurance. The guidance set forth in TB 85-4 is generally appropriate for all forms of COLI.

Under TB 85-4, a national bank should record its interest in the policy's CSV as an "other asset." The increase in the CSV over time would be recorded as "other noninterest income." In accordance with Call Report requirements, the bank should update its interest in the CSV at least quarterly.

APPLICATION OF THE GUIDELINES

The guidelines in this bulletin are applicable to all purchases of life insurance entered into after the date of this bulletin. Purchases of life insurance policies entered into before the date of this bulletin will be evaluated in the following manner.

Policies purchased after issuance of former Banking Circular (BC)-249, Bank Purchases of Life Insurance

Policies purchased after February 4, 1991, should comply with either the guidelines contained in former BC-249 or with the guidelines in this bulletin.

Policies Purchased before the issuance of former BC-249, Bank Purchases of Life Insurance

Policies purchased before February 4, 1991, are provided a "safe harbor" if the following three conditions are met:

- The policies are convenient or useful in connection with the conduct of the bank's business.
- The policies do not threaten the safety and soundness of the, institution.
- The policies do not represent insider abuse or violate other laws, rules, or regulations.

If these conditions are met, no further action by the bank is needed. However, the OCC may require corrective action at any time during the bank's ownership or while it has a beneficial interest in a policy, if any of the three conditions are not met. Such determinations will be made on a case by case basis.

ORIGINATING OFFICE

For further information about this bulletin, contact the Office of the Deputy Comptroller for Credit Risk at (202) 874-5170.

Emory W. Rushton
Senior Deputy Comptroller for Bank Supervision Policy

APPENDIX

COMMON TYPES OF LIFE INSURANCE POLICIES

Life insurance can be categorized into two broad types, temporary insurance and permanent insurance. There are numerous variations of these products. However, basic life insurance provisions generally fall within one or a combination of the following categories.

Temporary Insurance

Temporary insurance consists of the various forms of term insurance. Term insurance provides life insurance protection for a specified time period. Death benefits are payable only if the insured dies during the specified period. If a loss does not occur during the specified term, the policy lapses and provides no further protection. All premiums are retained by the insurance company. Typically, term insurance premiums do not have a "savings component"; thus, term insurance does not usually create cash value.

Permanent Insurance

Permanent insurance is intended to provide life insurance protection for the entire life of the insured. Permanent insurance also differs from term insurance in that its premium structure includes a "savings component." Permanent insurance policy premiums have two components, the insurance cost (mortality cost,[1] administrative fees, sales

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[1] Mortality cost represents the cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk. With term insurance, the insurance company is generally exposed to risk of loss for the entire face amount of the policy. With permanent insurance, the net amount at risk

loads, etc.) and the "savings component." The "savings component" typically is referred to as cash value. The policyholder may use the cash value to make the minimum premium payments necessary to maintain the death benefit protection, may access the cash value by taking out loans or making partial surrenders, or use any combination of these techniques. If permanent insurance is surrendered before death, a surrender charge may be assessed against the cash value. Generally, surrender charges are assessed if the policy is surrendered within the first 10 or 15 years. The amount of money a policyholder will receive upon surrendering a policy is referred to as the cash surrender value (CSV).

There are a variety of types of permanent insurance. Some of these include:

- Whole Life - A traditional form of permanent insurance designed so that fixed premiums are paid for the entire life of the insured. However, premiums may be paid from the CSV. Death benefit protection is provided for the life of the insured, assuming all premiums are paid.

- Universal Life - A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a very high cash value. Alternatively, the policyholder can make minimal payments in an amount just large enough to cover mortality and other expense charges.

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for the insurance company is the difference between the policy's death benefit and the cash value.

- General Account - form of whole or universal life insurance where the policyholder's cash value is supported by the general assets of the insurance company.

- Variable or Separate Account - form of whole life or universal life where the policyholder's cash value is supported by assets segregated from the general asset structure of the carrier. Theoretically, the cash value of a separate account insurance policy can go down to zero which would result in termination of the policy. The policyholder assumes all investment and price risk. The separate account is used solely for payment of policyholder benefits.

LIFE INSURANCE AS A FINANCING OR COST RECOVERY VEHICLE FOR BENEFITS PLANS

National banks may, as other corporations frequently do, use corporate-owned life insurance (COLI) as a financing or cost recovery vehicle for pre- and post-retirement employee benefits. In these arrangements, banks and other corporations insure the lives of certain employees to reimburse the corporation for the cost of employee benefits. The group of insured employees is often different from the group of employees who receive benefits. The corporation's obligation to provide employee benefits is separate and distinct from the purchase of the life insurance. The life insurance purchased by the corporation remains a corporate asset even after the employer/employee relationship is terminated. The employees, whether insured or not, have no interest in the insurance (other than their general claim against corporate assets arising from the corporation's obligation to provide the stated benefits). Permanent insurance is used for this purpose.

There are two common methods of financing or effecting cost recovery of employee benefits. The first is the cost recovery method. Under this method, the corporation sustains the cost of providing the employee benefits and the cost of purchasing the life insurance. The corporation holds the life insurance and collects the death benefit to reimburse the corporation for the cost of the benefits and the insurance.

The cost recovery method usually involves present value analysis. The corporation typically projects the dollar amounts of the expected benefits owed to employees and determines the present value of the benefits. Then, the corporation purchases a sufficient amount of life insurance on the lives of certain employees so that the gain (present value of the life insurance proceeds less the present value of the premium payments) from the insurance proceeds reimburses the corporation for the benefit payments.

The second method of financing employee benefits is known as cost offset. With this method, the corporation projects the annual employee benefit expense associated with the benefit plan. Then, the company purchases life insurance on the lives of certain employees. The amount of insurance purchased is great enough so that the income earned on the CSV offsets the benefit expense. The collection of death benefits may further enhance the company's return.

SPLIT-DOLLAR INSURANCE ARRANGEMENTS

National banks may, as many other corporations do, use split-dollar life insurance arrangements to provide retirement benefits and/or death benefits to certain employees. Under split-dollar arrangements, the employer and the employee share the rights to the policy's CSV and death benefits. The employer and the employee may share premium payments. If the employer pays the entire premium, the employee must

recognize the economic value of the insurance as taxable income each year. Typically, split-dollar arrangements are set forth in written contracts that specify the terms and conditions of the agreement between the employer and employee.

Split-dollar arrangements may be structured in a number of ways. However, there are three basic types of split-dollar arrangements.

Endorsement Split-Dollar

In endorsement split-dollar arrangements, the employer owns the policy and controls all rights of ownership. The employer provides the employee an endorsement of the death benefit provided to the employee under the plan agreement. The employee may designate a beneficiary for the designated portion of the death benefit.

Under this arrangement, the employer typically holds the policy until the employee's death. At that time, the employee's beneficiary receives the designated portion of the death benefits, and the employer receives the remainder of the death benefits.

Collateral Assignment Split-Dollar

The employee owns the policy and controls all rights of ownership. Under these arrangements, the employer usually pays the entire premium or a substantial part of the premium. The employee assigns a collateral interest in the policy to the employer that is equal to the employer's interest in the policy. The employer's interest in the policy usually is equal to the premium paid by the employer or the premium plus a return on the premium.

Under this arrangement, the employee upon retirement usually has an option to buy the employer's interest in the policy. The employee usually withdraws money from the cash value or borrows against the cash value to purchase the policy. Sometimes, the employer may give the employee a bonus to purchase the employer's interest in the policy, or the employer may simply give the employee the corporation's interest in the policy as a bonus. This transfer of the employer's interest to the employee is typically referred to as a "roll-out."

If a "roll-out" is not provided or exercised, the employer does not receive its interest in the policy until the employee's death. Upon the employee's death, the employer would receive an amount equal to the premium paid or the premium plus a return on the premium. The employee's beneficiary would receive the remainder of the death benefits.

If the employee dies before reaching retirement age, the insurance policy's death benefit may be divided a number of ways. For example, the employer may receive an amount equal to the premium paid or the premium plus a return on the premium, and the employee's beneficiary would receive the remainder of the death benefit. As an alternative, the employer may retain the policy's entire death benefit.

Reverse Split-Dollar

Reverse split-dollar arrangements are very similar to collateral assignment split-dollar. The employee owns the policy and the employee provides the employer with an endorsement of part of the death benefit. The employer's interest in the policy is usually equal to or closely related to the pure insurance protection and used as "key-person" insurance. The employer's share of the premium is equal to the economic value of the pure insurance protection. The

employee's interest in the policy is typically equal to or closely related to the cash value of the policy. The employee pays the remainder of the premium. This type of split-dollar arrangement is not frequently used in banks.

Split-Dollar Insurance Arrangements Used for Estate Planning Purposes or to Fund Buy-Sell Agreements

National banks may use split-dollar insurance arrangements as an estate planning tool for insiders or to fund buy-sell arrangements between the bank and insiders. However, such arrangements should be part of a reasonable compensation program. As stated in part VII of the pre-purchase analysis, national banks should combine the additional compensation provided to the insured by the split-dollar arrangement with all other compensation provided to the insured. Furthermore, national banks should ensure that total compensation provided to the insured is not excessive. Excessive compensation is prohibited as an unsafe and unsound practice. Guidelines for determining excessive compensation can be found in Appendix A to 12 CFR Part 30-Interagency Guidelines Establishing Standards for Safety and Soundness.

Typically, shareholders and other insiders who are not bank employees or directors do not provide goods or services to the bank and do not receive compensation. Therefore, national banks should only participate in such arrangements as a means of providing compensation for goods or services provided by insiders.

"KEY-PERSON" INSURANCE

A national bank may obtain life insurance to protect itself against the loss of "key-persons." As such, a national bank may purchase insurance on the life of an employee whose

death would be of such consequence to the bank as to give it an insurable interest in his or her life. Certain directors of the bank may also be "key-persons."

The purpose of "key-person" insurance is to indemnify the bank against a potential loss of net income that may result from the untimely death of the insured employee. The determination of whether an individual is a "key-person" does not turn on that individual's status as an officer, but on the nature of the individual's economic contribution to the bank.

The first step in indemnifying a bank against the loss of a "key-person" is to identify the "key-person." In essence, a "key-person" is anyone whose absence for an extended period of time would result in a significant loss of net income for the bank. The next and possibly most difficult step is estimating the value of the "key-person." The value of the employee is an estimate of the potential loss of net income that the bank may incur from the untimely death of the "key-person." This value should be an estimate of the impact on net income from the loss of revenues, increased expenses, loss of operating efficiency, or other profit reductions that may result from the untimely death of the "key-person." This estimate of loss should represent a significant amount of the bank's profit or profit potential.

Determining the value of a "key-person" is not easy. Also, the most appropriate method for determining the value of a "key-person" is dependent upon the individual circumstances that created the "key-person" status. For these reasons, the OCC has not established a formula nor a specific process for estimating the value a "key-person" brings to a bank. Instead, the OCC affords bank management the opportunity to consider and analyze all relevant factors, and use their judgment to make the decision.

Additionally, "key-person" life insurance should not be used in place of, and does not diminish the need for, adequate management c ey person" succession planning. Indeed, if a bank has adequate management or "key-person" succession plan, its reliance on a "key-person" should decline as the person gets closer to retirement. Since a bank's reliance on a "key-person" declines as the individual moves toward retirement, the potential loss of net income which may result from the death of a "key-person" also should diminish.

As previously stated, holding permanent insurance in an amount in excess of the bank's risk of loss may be an unsafe and unsound practice.[2] Once an individual, because of retirement, resignation, discharge, change of responsibilities, or for any other reason, is no longer a "key-person" for the bank, the bank's risk of loss has been eliminated. Therefore, national banks may be required to surrender or otherwise dispose of life insurance held on a former "key-person." For this reason, the economic consequences of terminating the insurance should be considered in selecting the type of insurance and in structuring the policy. Typically, term or declining term insurance may be the most appropriate form of life insurance for "key-person" protection. It also may be appropriate to use permanent insurance that allows the substitution of insureds to provide for this protection.

LIFE INSURANCE ON BORROWERS

State law generally recognizes that a lender has an insurable interest in the life of a borrower to the extent of the borrower's obligation to the lender. In some states, the lender's insurable interest may equal the borrower's

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[2] See part (II), Quantification of the Amount of Insurance Needed, of the pre-purchase analysis on page 4 of the bulletin.

obligation plus the cost of insurance and the time value of money. Furthermore, national banks may protect themselves against the risk of loss from the death of a borrower. That protection may be provided through self-insurance in the form of debt cancellation contracts, or by the purchase of life insurance policies on borrowers.

National banks can take two approaches in purchasing life insurance on borrowers. First, a national bank can purchase life insurance on an individual borrower for the purpose of protecting the bank specifically against loss arising from that borrower's death. Second, a national bank may employ a cost recovery technique similar to that used in conjunction with employee benefit plans. Under this method, the bank insures a group of borrowers in a homogenous pool of loans for the purpose of protecting the bank from loss arising from the death of any borrower in the homogenous pool. Examples of homogenous pools of loans include consumer loans that have distinctly similar characteristics such as automobile loans, credit card loans, and residential real estate mortgages.

Regardless of which approach is used, national banks should adhere to part 11 of the pre-purchase analysis. That is, banks should determine the risk of loss and ensure that the amount of insurance purchased is not excessive in relation to that estimate. When purchasing insurance on individual borrowers, bank management should, given the facts and circumstances known at the time of the insurance purchase, take reasonable efforts to ensure that the expected insurance proceeds match the expected repayment terms of the debt. To accomplish this, management should estimate the risk of loss over the life of the loan and match the anticipated insurance proceeds to the risk of loss. The insurance policy should be structured so that the expected death proceeds never substantially exceed the risk of loss. Generally, the

risk of loss will be closely related to the outstanding principal of the debt. To properly structure the insurance policy, consideration should be given to the repayment terms of the debt. For example, for amortizing credit, banks should typically choose declining term insurance where the death proceeds are decreasing in amounts that match the loan amortization.

As previously stated, holding permanent insurance in an amount in excess of the bank's risk of loss may be an unsafe and unsound practice.[3] Once a credit is repaid, otherwise satisfied in full, or charged-off, the bank's risk of loss has been eliminated. Therefore, national banks may be required to surrender or otherwise dispose of life insurance on individual borrowers under these circumstances. For this reason, the economic consequences of terminating the insurance should be considered in selecting the type of insurance and in structuring the policy. Typically, term or declining term insurance is the most appropriate form of life insurance for insuring the lives of individual borrowers.

When purchasing life insurance on borrowers in a homogenous pool of loans, bank management should, given the facts and circumstances known at the time of the insurance purchase, take reasonable efforts to match the insurance proceeds on an aggregate basis to the total outstanding loan balances. If allowed by state law, national banks may match the insurance proceeds to the outstanding loan balances plus the cost of insurance on either a present value or future value basis. This relationship should be maintained throughout the duration of the program. When using this aggregate or group concept, it is acceptable for banks to continue to hold policies on the lives of borrowers

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[3] See part (II), Quantification of the Amount of Insurance Needed, of the pre-purchase analysis on page 4 of the bulletin.

that have been charged-off. However, loans in the homogeneous pool cannot include loans that have been charged-off. This will help ensure that national banks using this approach do not hold life insurance once the risk of loss has been eliminated.

The purchase of life insurance on a borrower is not an appropriate mechanism for effecting a recovery on obligations that have been charged-off, or are expected to be charged-off for reasons other than the borrower's demise. In the case of charged-off loans, the purchase of life insurance does not protect the bank from a risk of loss since the loss has already occurred. Since the insurance does not protect the bank from a risk of loss, the bank does not need the insurance. Holding insurance the bank does not need may subject the bank to unwarranted risks, an unsafe and unsound banking practice. In the case of loans the bank expects to charge-off for reasons other than the borrower's demise, the risk of loss is so pronounced that the purchase of life insurance by the bank would be purely speculative and an unsafe and unsound banking practice.

LIFE INSURANCE AS SECURITY FOR LOANS

National banks may take an interest in an existing life insurance policy as security for a loan. National banks also may make loans to individuals to purchase life insurance, taking a security interest in the policy. As with any other type of lending, extensions of credit secured by life insurance should be made on terms that are consistent with safe and sound banking practices. For instance, the borrower should be obligated to repay the loan according to an appropriate amortization schedule.

Generally, a national bank may not rely on its security interest in a life insurance policy to extend credit on terms

that excuse the borrower from making interest and principal payments during the life of the borrower with the result that the bank is repaid only when the policy matures at the death of the insured. Lending on such terms is generally speculative and an unsafe and unsound banking practice.

Frequently, banks acquire ownership of life insurance policies through debts previously contracted (DPC). That is, banks invoke their security interest in a policy after a borrower defaults. Life insurance policies do not have a secondary market. National banks should surrender or otherwise dispose of permanent life insurance acquired through DPC within a short time frame, generally 90 days, of obtaining control of the policy. It is possible that a national bank may find a means to dispose of permanent life insurance acquired through DPC which would require a longer holding period. Therefore, a national bank may request an extended holding period from its supervisory office. In order to receive an extension, the bank should have a well-documented plan that is reasonably certain to allow the bank to dispose of the policy through means other than speculating on the death of the insured. Additionally, the extended holding period should be in the best interest of the bank.

National banks may retain temporary insurance until the next renewal date or the next premium date, whichever comes first. National banks may not continue to make premium payments on term insurance acquired through DPC. This activity is speculative and an unsafe and unsound banking practice.

APPENDIX M

Mich. Comp. Laws § 500.2210 (1990)

500.2210 Insurable interest; employer.
[M.S.A. 24.12210]

Sec. 2210. **(1)** As used in this section, "employer" means an individual, sole proprietorship, partnership, firm, corporation, association, or any other legal entity, which has 1 or more employees and is legally doing business in this state.

(2) Notwithstanding any other section of this code, an employer has an insurable interest in, and may, with the consent of the insured, insure on an individual or group basis for its benefit or for the benefit of an employer-sponsored trust for the benefit of its employees, the lives of its directors, officers, managers, nonmanagement employees, and its retired employees. An employer may insure the lives of its nonmanagement employees and its retired employees only if those persons consent to be insured and the coverage is limited to an amount reasonably commensurate with the employer's projected unfunded liabilities to nonmanagement and retired employees for welfare benefit plans, as defined by the employee retirement income security act of 1974, Public Law 93-406, 88 Stat. 829, calculated according to accepted actuarial principles. An employer shall not retaliate in any manner against an employee or a retired employee for refusing consent to be insured.

(3) The proceeds of any policy or certificate issued pursuant to subsection (2) is exempt from the claims of any creditor or dependent of the insured.

Approved December 21, 1990.
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OPPOSITION BRIEF

No. 06-478

In the Supreme Court of the United States

DOW CHEMICAL COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the court of appeals correctly held that petitioner's transactions involving its corporate-owned life insurance plans lacked economic substance, and that petitioner was therefore not entitled to take tax deductions for interest and fees related to those plans, after discounting the possibility that petitioner would make uncharacteristically large cash contributions to the plans in the future.

2. Whether the court of appeals applied the correct standard of review in determining that petitioner's transactions lacked economic substance.

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BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-34a) is reported at 435 F.3d 594. The opinion of the district court (Pet. App. 35a-186a) is reported at 250 F. Supp. 2d 748.

JURISDICTION

The judgment of the court of appeals was entered on January 23, 2006. A petition for rehearing was denied on May 24, 2006 (Pet. App. 205a-206a). On July 25, 2006, Justice Stevens extended the time within which to file a petition for a writ of certiorari to and including October 6, 2006. The petition was filed on October 4, 2006. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. As the name suggests, corporate-owned life insurance (COLI) is life insurance purchased by a corporation in order to insure the lives of its employees. Corporations originally purchased those policies in order to protect themselves from financial loss resulting from the death of key employees. Increasingly, however, corporations attempted to use those policies in order to reduce their federal income tax liability: namely, by obtaining loans on the policies (using the cash value of the policies as collateral), using those loans to pay most of the premiums on the policies, and then deducting the interest on the loans.

In 1986, Congress sought to curtail that practice by prohibiting a corporation from deducting the interest on any loan over $50,000 made in connection with a COLI policy. See 26 U.S.C. 264(a)(4) (1994). After that limitation was enacted, corporations began using "broad-based" COLI plans, under which they would purchase life insurance for a much greater number of their employees. Those plans were designed to circumvent the per-policy limitation on deductions for interest on COLI-related loans, and thereby to manufacture massive interest deductions that could be used to shelter unrelated income from taxation. See Department of the Treasury, *Report to the Congress on the Taxation of Life Insurance Company Products* 14 (1990). In 1996, Congress effectively ended that practice by limiting the number of employees as to whom a deduction for COLI-related interest could prospectively be taken. See 26 U.S.C. 264(a)(4) and (e).

b. Even when a taxpayer would otherwise qualify for a deduction under the Internal Revenue Code, the de-

duction may still be disallowed if the underlying transaction lacks economic substance, *i.e.*, if "there was nothing of substance to be realized by [the taxpayer] from th[e] transaction beyond a tax deduction." *Knetsch* v. *United States*, 364 U.S. 361, 366 (1960); see *Gregory* v. *Helvering*, 293 U.S. 465, 469-470 (1935). Before this case, three courts of appeals, applying the economic-substance doctrine, had disallowed tax deductions arising from "broad-based" COLI plans. See *American Elec. Power Co.* v. *United States*, 326 F.3d 737, 740-745 (6th Cir. 2003), cert. denied, 540 U.S. 1104 (2004); *In re CM Holdings, Inc.*, 301 F.3d 96, 102-107 (3d Cir. 2002); *Winn-Dixie Stores, Inc.* v. *Commissioner*, 254 F.3d 1313, 1315-1317 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002).

2. In 1988 and 1991, petitioner, a major corporation, purchased two COLI plans that insured the lives of more than 21,000 of its employees. From 1988 to 2000, petitioner "paid" for its premiums on those policies primarily by simultaneously taking loans on the policies (using the cash value of the policies as collateral) or by simultaneously making partial withdrawals from the portion of the cash value that had not already been used as collateral. Petitioner "paid" for nearly all of the interest on its loans in the same manner. Although petitioner "paid" nearly $1.6 billion in premiums and interest over that period, petitioner actually disbursed less than $150 million in cash to the insurers. Pet. App. 3a-5a.

Under both plans, the insurers charged a higher interest rate for loans to petitioner than they used in crediting the values of the policies. Accordingly, both plans were projected to generate negative pretax cash flows for the first 17 or 18 years of their existence. After that

time, if petitioner made massive cash infusions for approximately 10 to 12 years, the plans would eventually generate positive cash flows—but not until some 40 years had passed since their inception. Petitioner was under no obligation to make such massive cash infusions. Even if petitioner did make those infusions, moreover, it was unclear whether the net present value of the cash flows from the plans would be positive or negative, with the answer depending on the discount rate used in the analysis. In addition, both plans had features that protected the insurers from the losses that would result from unexpectedly high mortality rates among the insured employees. Pet. App. 5a-6a, 83a, 89a-94a, 103a-107a.

On its income tax returns for 1989 to 1991, petitioner claimed deductions of over $33 million for interest paid on loans used to pay COLI premiums (and for administrative fees related to the COLI plans). On May 23, 2000, the Internal Revenue Service disallowed the deductions, and assessed tax deficiencies and interest totaling more than $22 million. Pet. App. 6a n.5, 118a-119a.

3. After paying the assessed amounts, petitioner filed a refund suit in the United States District Court for the Eastern District of Michigan. The district court held a bench trial, at which the government presented evidence that petitioner intended to engage in tax arbitrage through the COLI plans. See Gov't C.A. Br. 6-27 (summarizing evidence). At the conclusion of trial, however, the district court entered judgment in favor of petitioner. Pet. App. 35a-186a. The district court recognized that other courts had "generally determined that the ['broad-based'] COLI plans constituted economic shams, functioning only as interest-deduction engines

that drove no legitimate financial vehicles." *Id.* at 57a. In this case, however, the district court ultimately concluded that "there was an economic benefit that potentially could be derived from the plans without relying solely on the tax deductions for policy loan interest." *Id.* at 58a.

As is relevant here, the district court rejected the government's arguments (1) that petitioner's plans were projected to generate negative pretax cash flows; (2) that petitioner would not benefit from the accrual of interest on the cash value of the policies; and (3) that petitioner's ability to realize mortality gains from the plans was limited. Pet. App. 128a-153a. The court noted that "there are prepurchase illustrations that show positive cash flow coming from the plan[s] even without the tax deduction for policy loan interest." *Id.* at 131a; see *id.* at 148a. The court rejected the government's contention that "these illustrations are not reliable because * * * they rely on a payment strategy which [petitioner] would not likely adopt because it would require the infusion of significant amounts of cash in the middle years of the plan." *Id.* at 131a; see *id.* at 148a. Instead, the district court, crediting testimony from petitioner's officials, found that petitioner intended to make those cash infusions. *Id.* at 134a. The court further reasoned that, in determining whether petitioner's plans would generate positive pretax cash flows, it was required to "evaluate[] the transaction as a whole." *Id.* at 142a. After accepting petitioner's proposed after-tax discount rate for the net present value of the cash flows from the plans, the court concluded that petitioner had "demonstrate[d] a substantial, non-tax benefit." *Id.* at 143a; see *id.* at 150a.

Additionally, the district court determined that the transactions did not lack economic substance insofar as the plans contained mechanisms limiting the insurers' risk of suffering mortality losses. The court reasoned that the plans did not entirely *eliminate* the insurers' risk. Pet. App. 145a-146a, 150a-152a.

4. The court of appeals reversed. Pet. App. 1a-34a.

a. At the outset, the court of appeals noted that a district court's "ultimate conclusion" that petitioner's transactions had economic substance was subject to *de novo* review. Pet. App. 9a. At the same time, the court stated that any underlying factual findings were reviewed only for clear error. *Id.* at 8a. The court further observed that both parties had agreed on the appropriate standard of review. *Id.* at 9a n.8.

Turning to the merits, the court of appeals explained that, in determining whether similar transactions involving COLI plans had economic substance, courts had looked to "several indicators of the COLI plans' potential economic benefits: (i) projected pre-deduction cash flows, [(ii)] mortality gains to the beneficiary, who does not pay tax on proceeds, and [(iii)] interest-free inside build-up [the accrual of interest on the policy value]." Pet. App. 10a (internal quotation marks and citations omitted; brackets in original). The court of appeals proceeded to "examine the objective economic substance of [petitioner's] COLI plans against each of these standards." *Ibid.*

With regard to pre-deduction cash flows, the court of appeals noted that the district court had found that petitioner "intended to inject large amounts of cash into the plans in their middle years." Pet. App. 11a. The court of appeals reasoned, however, that the critical inquiry was whether "such highly-contingent cash flows are rel-

evant as a matter of law to the economic-sham analysis." *Ibid.* If they were not, the court explained, "it would undermine the finding that the plans would generate positive cash flows in their later years, which would in turn preclude the finding that each plan had a positive [net present value]." *Ibid.*

The court of appeals concluded that "the district court erred in including in its cash-flow analysis the highly-contingent positive cash flows projected for later years." Pet. App. 14a-15a. The court of appeals reasoned that, under this Court's decision in *Knetsch*, *supra*, "[c]ourts may consider future profits contingent on some future taxpayer action, but only when that action is consistent with the taxpayer's actual past conduct." Pet. App. 13a. On the other hand, "[c]ourts should be skeptical * * * when the asserted future profits hinge on future taxpayer action that seriously departs from past conduct, especially where such departure involves the expenditure of large sums of money." *Ibid.*

Applying those principles, the court of appeals determined that "the instant COLI plans would become profitable only upon the taxpayer's large future outlay of additional cash, and, considering [petitioner] had heretofore made no similar cash infusions, such additional spending would be a drastic departure from the taxpayer's past conduct." Pet. App. 13a-14a. The court further noted that "there was no contractual provision requiring [petitioner] to make substantial cash infusions in the future." *Id.* at 14a. Having concluded that "the future positive cash flows [in this case] should have been ignored," the court determined that, "[w]hen the future infusion of cash is properly removed from the analysis, only negative cash flows remain." *Id.* at 15a. The court similarly determined that, absent the future cash infu-

sion, "[petitioner] would have been unable to realize the benefit of inside build-up," *i.e.*, the accrual of interest on the cash value of the policies. *Id.* at 16a.

With regard to mortality gains, the court of appeals held that the district court erred by holding that petitioner's transactions would lack economic substance only if the plans entirely eliminated the insurers' risk of mortality losses. Pet. App. 17a-20a. The court of appeals reasoned that, in two of the three previous cases involving tax deductions related to "broad-based" COLI plans, "[the] challenged plans clearly did *not* eliminate 100% of all mortality gains and losses." *Id.* at 18a. The court also noted that "it is clear that the COLI plans were designed to reduce (even if not by 100%) [petitioner's] ability to realize mortality gains," and that "[the plans'] features are sufficiently similar to the other COLI-plan cases for us to conclude that [petitioner] would not significantly benefit from mortality gains." *Id.* at 20a.

Because petitioner's COLI plans "did not generate any of [the] benefits" discussed in earlier cases, the court of appeals concluded that petitioner's COLI-related transactions lacked economic substance. Pet. App. 20a.

b. Judge Ryan dissented. He reasoned that this Court's decision in *Knetsch* stood only for the proposition that potential future cash flows were irrelevant to the economic-substance analysis where "the taxpayer did not *intend* to make the * * * future investment" at issue. Pet. App. 22a. Having concluded that petitioner's potential future cash infusion was relevant as a matter of law, Judge Ryan agreed with the district court that petitioner would have realized the benefit of inside build-up on its plans. *Id.* at 23a-27a. Judge Ryan also "disagree[d] * * * that the district court committed

legal error" in concluding that petitioner's COLI plans were not mortality-neutral for purposes of the economic-substance doctrine. *Id.* at 27a. He reasoned that the plans in each of the two previous cases discussed by the majority were in fact designed to eliminate all mortality gains, *id.* at 28a-29a, and that the plans in this case were therefore distinguishable from those plans, *id.* at 29a.

5. The court of appeals denied a petition for rehearing, with Judge Ryan indicating that he would have granted panel rehearing. Pet. App. 205a-206a.

ARGUMENT

1. Petitioner contends (Pet. 19-30) that, in holding that petitioner's transactions involving its COLI plans lacked economic substance, the court of appeals erred by discounting the possibility that petitioner would make uncharacteristically large cash contributions to the plans in the future. The court of appeals' decision in that regard was correct and does not conflict with any decision of this Court or another court of appeals.

a. As a preliminary matter, petitioner does not contend that the court of appeals' ultimate holding—*i.e.*, that petitioner's transactions involving its COLI plans lacked economic substance—conflicts with the holding of any other court of appeals. Nor could petitioner advance such a claim, because, as the court of appeals recognized (Pet. App. 9a-10a), all of the courts of appeals to have previously considered the issue similarly disallowed tax deductions arising from "broad-based" COLI plans under the economic-substance doctrine. See *American Elec. Power Co.* v. *United States*, 326 F.3d 737, 740-745 (6th Cir. 2003), cert. denied, 540 U.S. 1104 (2004); *In re CM Holdings, Inc.*, 301 F.3d 96, 102-107 (3d Cir. 2002); *Winn-Dixie Stores, Inc.* v. *Commis-*

sioner, 254 F.3d 1313, 1315-1317 (11th Cir. 2001), cert. denied, 535 U.S. 986 (2002).

b. Instead, petitioner contends only that the court of appeals erred by discounting the possibility that petitioner would make uncharacteristically large cash contributions to the plans in the future in determining, as part of its analysis under the economic-substance doctrine, (1) that petitioner's plans were projected to generate negative pretax cash flows and (2) that petitioner would not benefit from the accrual of interest on the cash value of the policies. See Pet. App. 10a-16a. This case, however, would constitute a poor vehicle for consideration of any question concerning the legal relevance of the possibility of future contributions under the economic-substance doctrine, because even a ruling in petitioner's favor on that issue would not necessarily change the ultimate conclusion that petitioner's transactions lacked economic substance. In addition to determining that petitioner's plans were projected to generate negative pretax cash flows and that petitioner would not benefit from the accrual of interest on the cash value of the policies, the court of appeals determined that petitioner's ability to realize mortality gains from the plans was significantly limited. See *id.* at 17a-20a. Petitioner does not challenge that determination before this Court.

Moreover, in light of its decision to discount the possibility that petitioner would make uncharacteristically large cash contributions to the plans in the future, the court of appeals did not reach the government's alternative arguments as to why petitioner's plans were projected to generate negative pretax cash flows—most notably, the argument that the district court used an erroneously low after-tax discount rate. See Pet. App. 15a. Because the alleged error by the court of appeals

was not clearly outcome-dispositive, further review of that alleged error in this case is not merited.

c. In any event, in applying the economic-substance doctrine, the court of appeals correctly discounted the possibility that petitioner would make uncharacteristically large cash contributions to the plans in the future. In so doing, the court of appeals relied on a footnote in this Court's decision in *Knetsch* v. *United States*, 364 U.S. 361 (1960), for the proposition that a court may not consider future profits that are contingent on a taxpayer's voluntary future conduct when that conduct would constitute a "drastic departure" from the taxpayer's previous conduct. Pet. App. 14a.

Contrary to petitioner's contention (Pet. 19-21), the court of appeals correctly applied *Knetsch*. The taxpayer in *Knetsch* claimed tax deductions for interest on loans used to pay for annuity savings bonds; the taxpayer claimed that his transactions involving the bonds had economic substance because the bonds would eventually produce monthly annuity payments or insurance proceeds. 364 U.S. at 362-366. The Court rejected that argument on the ground that petitioner "kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000." *Id.* at 366. In the footnote cited by the court of appeals, the Court rejected the taxpayer's argument that "in 10 years the net cash value of the bonds would have exceeded the amounts [the taxpayer] paid as 'interest,'" on the ground that "[t]his contention * * * is predicated on the wholly unlikely assumption that [the taxpayer] would have paid off in cash the original $4,000,000 'loan.'" *Id.* at 366 n.3.

The better reading of that footnote is that, in assessing the pretax profitability of a scheme for purposes of

the economic-substance doctrine, a court should discount a taxpayer's future contributions when those contributions are "wholly unlikely," as an objective matter, in light of the taxpayer's previous conduct—not, as the dissent in this case asserted (Pet. App. 22a), that a court should discount a taxpayer's future contributions only when the court expressly finds that the taxpayer did not actually *intend* to make them. Thus, even if the ultimate inquiry focuses on "*the factual probability* of [a taxpayer's] claimed investment actually being made," as petitioner contends (Pet. 20-21), the court of appeals correctly applied *Knetsch* in holding that, when a taxpayer's voluntary future investment would represent a "drastic departure" from its previous conduct, that investment is sufficiently unlikely that, regardless of the taxpayer's stated intention, the possibility that the investment would be made can be discounted as a matter of law.[1]

d. Petitioner contends (Pet. 21-27) that, by discounting the possibility that petitioner would make uncharacteristically large cash contributions to the plans in the future for purposes of applying the economic-substance doctrine, the court of appeals' decision conflicts with

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[1] In the alternative, petitioner suggests (Pet. 28-29) that its future cash contributions would not represent a "drastic departure" from its previous conduct. The court of appeals noted, however, that petitioner would have to contribute around $315 million in order to make its COLI plans profitable—more than twice the amount that petitioner had contributed to the plans between 1988 and 2000. Pet. App. 5a, 10a n.9. And far from holding that no "future investment would ever be entitled to be considered" (Pet. 29), the court of appeals expressly "le[ft] for another day the consequences of less drastic departures." Pet. App. 14a n.13. In any event, the case-specific question whether the hypothetical future contributions would represent a "drastic departure" from past conduct plainly does not merit review by this Court.

various decisions of this Court and other courts of appeals. That contention lacks merit.

The court of appeals' decision is consistent with this Court's decisions in *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), and *Commissioner* v. *Duberstein*, 363 U.S. 278 (1960). In *Frank Lyon*, the Court held that a transaction involving a sale-leaseback arrangement had economic substance, and therefore allowed a taxpayer to claim depreciation and interest deductions relating to the arrangement. 435 U.S. at 583-584. In rejecting the government's contention that the bank that originally sold the property (and then leased it back from the taxpayer) was effectively the owner of the property, the Court credited the district court's finding that "it was highly unlikely, as a practical matter, that any purchase option [by the bank] would ever be exercised." *Id.* at 570; see *id.* at 581. To the extent that the Court used an objective standard in disregarding potential future events relevant to application of the economic-substance doctrine, that standard was analogous to the objective standard used by the Court in *Knetsch* (and by the court of appeals in this case) in disregarding a taxpayer's own potential future conduct.

In *Duberstein*, the Court did not invoke the economic-substance doctrine at all, but instead merely determined whether certain transfers of property constituted "gifts" for purposes of the Internal Revenue Code. See 363 U.S. at 279-280. *Duberstein* therefore has no bearing on the question presented here: *i.e.*, under what circumstances a court should discount the possibility of a taxpayer's voluntary future investment in determining whether a scheme is profitable for purposes of the economic-substance doctrine.

Similarly, the court of appeals' decision does not conflict with any of the decisions of other courts of appeals cited by petitioner. Most of those decisions involve arrangements that are plainly distinguishable from the arrangement at issue here, and do not present any question concerning the relevance of a taxpayer's own potential future conduct. See *Sacks* v. *Commissioner*, 69 F.3d 982, 983-986 (9th Cir. 1995) (sale-and-leaseback arrangement similar to arrangement in *Frank Lyon*); *Bailey* v. *Commissioner*, 912 F.2d 44, 46-47 (2d Cir. 1990) (exchange of nonrecourse notes for stream of payments of arguably lower value); *Odend'hal* v. *Commissioner*, 748 F.2d 908, 908-912 (4th Cir. 1984) (exchange of nonrecourse notes for property of lower value), cert. denied, 471 U.S. 1143 (1985).

Among the cases cited by petitioner, the only even arguably comparable case is *Shirar* v. *Commissioner*, 916 F.2d 1414 (9th Cir. 1990). In that case, the taxpayer had purchased a life-insurance policy for his wife in order to cover anticipated estate-tax liability that would result from her death, and had paid the premiums in part with loans on the policy. *Id.* at 1416. The court of appeals concluded that transactions related to the policy had economic substance. *Id.* at 1416-1418. It was far from clear in that case, however, that the taxpayer's policy would generate negative pretax cash flows, or that the taxpayer would not benefit from the accrual of interest on the cash value of the policy, unless the taxpayer made voluntary future investments that would represent a "drastic departure" from his previous conduct. Cf. *id.* at 1416 (noting only that the taxpayer would not use loans to fund his premiums for the fourth through seventh years of the policy). Moreover, as the court explained, the taxpayer unambiguously received a

non-tax benefit from the policy, because, "absent the increased insurance coverage * * *, [the taxpayer] would not have had sufficient liquidity to meet the estate tax obligations upon the death of his wife." *Id.* at 1418. And the policy at issue, unlike the policy here, does not appear to have contained any features that would protect the insurer from losses resulting from premature mortality. Because *Shirar* is plainly distinguishable on its facts and does not hold that it is inappropriate to discount the possibility that a taxpayer would make uncharacteristically large cash contributions to an insurance plan in the future for purposes of applying the economic-substance doctrine, it does not conflict with the court of appeals' decision in this case.

e. Finally, even if petitioner could identify a conflict that might otherwise warrant the Court's review, this case would constitute a poor vehicle for consideration of any question concerning the relevance of potential future investment under the economic-substance doctrine because it arises in a context of little if any prospective importance. In 1996, Congress effectively ended the prospective use of "broad-based" COLI plans to manufacture massive interest deductions for the purpose of sheltering unrelated income from taxation. See 26 U.S.C. 264(a)(4) and (e). We are aware of only one other pending case concerning the application of the economic-substance doctrine to such "broad-based" COLI plans. In the event that another court of appeals were subsequently to reject the approach of the court of appeals below, this Court could grant review to address the question identified by petitioner. In this case, however, further review on that question is unwarranted.

2. Petitioner also claims (Pet. 13-19) that the court of appeals erred by applying *de novo* review to the dis-

trict court's ultimate determination that its transactions had economic substance.[2] That claim likewise does not warrant further review.

a. In this case, the court of appeals explained that, while a district court's underlying factual findings are reviewed only for clear error, a district court's "ultimate conclusion" as to whether a transaction had economic substance is subject to *de novo* review. Pet. App. 8a-9a. That description of the applicable standard of review is correct. As this Court explained in *Frank Lyon* (in holding that a transaction involving a sale-leaseback arrangement had economic substance), "[t]he general characterization of a transaction for tax purposes is a question of law subject to review," whereas "[t]he particular facts from which the characterization is to be made are not so subject." *Frank Lyon*, 435 U.S. at 581 n.16.[3] That standard of review, moreover, is consistent with the standard of review applicable to similar "mixed"

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[2] The same question is presented in *Coltec Industries, Inc.* v. *United States*, petition for cert. pending, No. 06-659 (filed Nov. 8, 2006). Unlike the petitioner in *Coltec Industries*, petitioner in this case does not contend that the court of appeals applied an erroneous *substantive* standard in determining that the relevant transactions lacked economic substance.

[3] Petitioner contends (Pet. 17) that "this statement did not squarely address the proper standard of review for the determination whether a transaction has economic substance." The Court made the quoted statement, however, in the course of rejecting the government's contention that the taxpayer, although the nominal owner of the property purchased from and leased back to the bank, was not in substance the true owner entitled to take depreciation deductions. See *Frank Lyon*, 435 U.S. at 581. Moreover, the Court cited as authority for its statement of the standard of review a Fourth Circuit decision that similarly involved the economic-substance doctrine. See *id.* at 581 n.16 (citing *American Realty Trust* v. *United States*, 498 F.2d 1194, 1198 (4th Cir. 1974)).

questions of law and fact. See, *e.g.*, *Ornelas* v. *United States*, 517 U.S. 690, 696-697 (1996) (applying *de novo* review to "ultimate determinations of reasonable suspicion and probable cause," while recognizing that clear-error review applies to the "determination of historical facts" underlying that ultimate determination); cf. *Salve Regina Coll.* v. *Russell*, 499 U.S. 225, 233 (1991) (noting that more deferential review of "mixed" questions is warranted only where "the district court is better positioned than the appellate court to decide the issue in question or * * * probing appellate scrutiny will not contribute to the clarity of legal doctrine") (internal quotation marks and citation omitted).

Petitioner correctly notes (Pet. 14 n.7) that several courts of appeals have stated that a district court's determination as to whether a transaction had economic substance was reviewable only for clear error. See, *e.g.*, *Nicole Rose Corp.* v. *Commissioner*, 320 F.3d 282, 284 (2d Cir. 2002); *ASA Investerings P'ship* v. *Commissioner*, 201 F.3d 505, 511 (D.C. Cir.), cert. denied, 531 U.S. 871 (2000); *ACM P'ship* v. *Commissioner*, 157 F.3d 231, 245 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999); *Yosha* v. *Commissioner*, 861 F.2d 494, 499 (7th Cir. 1988); *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 92 (4th Cir. 1985). As petitioner concedes (Pet. 15), however, those decisions "[f]or the most part * * * have engaged in rote recital of conclusory language from earlier opinions, with little analysis"—and it is therefore unclear, with regard to at least some of those decisions, whether the courts were deferring to the ultimate determination on economic substance, or merely to underlying factual determinations that may have been dispositive of that ultimate determination. Moreover, as petitioner seemingly also concedes (Pet.

17), to the extent that those courts did hold that a district court's ultimate determination on economic substance was reviewable only for clear error, those decisions cannot be reconciled with this Court's statement of the applicable standard of review in *Frank Lyon*.

b. In any event, this case does not provide the Court with a suitable opportunity to revisit any question concerning the standard of review applicable to a district court's ultimate determination on economic substance, because petitioner did not preserve any argument that such a determination should be subject to deferential review. Far from "argu[ing] against *de novo* review," as petitioner now contends (Pet. 9 n.3), petitioner ultimately conceded in the court of appeals that, "for purposes of this appeal, * * * the ultimate conclusion on economic substance is reviewed de novo," and further agreed with the government that "legal standards are reviewed de novo and factual findings under the 'clearly erroneous' test." Pet. C.A. Br. 38; see Gov't C.A. Br. 33 (same). Petitioner proceeded to contend that the district court's underlying findings—such as its finding that petitioner intended to build equity in its COLI plans—were not clearly erroneous. See, *e.g.*, Pet. C.A. Br. 46-67.[4] Accordingly, it is unsurprising that the court of appeals, without extended discussion, articulated the standard of review in the same way as petitioner. Pet. App. 8a-9a.[4]

This case would constitute a poor vehicle for considering the standard-of-review question now raised by

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[4] Moreover, although petitioner sought rehearing on the court of appeals' substantive holdings, it did not seek rehearing on the standard-of-review issue. See, *e.g.*, Pet. for Reh'g 14 (seemingly conceding that the standard of review in the court of appeals for the ultimate determination on economic substance was "now" *de novo*).

petitioner for another reason. In reversing the decision of the district court, the court of appeals did not overturn any of the district court's factual findings (as petitioner acknowledges, see Pet. 2, 9), but instead held that (1) the district court erred by failing to discount the possibility that petitioner would make uncharacteristically large cash contributions to the plans many years into the future, see Pet. App. 10a-16a, and (2) the district court erred by concluding that petitioner's transactions would lack economic substance only if the plans entirely eliminated the insurers' risk of mortality losses, see *id.* at 17a-20a. Both of those errors were unquestionably *legal* in nature, as the court of appeals repeatedly noted. See, *e.g.*, *id.* at 11a (stating that the relevant question was whether "such highly-contingent cash flows are relevant as a matter of law to the economic-sham analysis"); *id.* at 12a (referring to that question as a "legal question"); *id.* at 15a (holding that "[petitioner's] putative additional outlay * * * should be disregarded as a matter of law"); *id.* at 19a (rejecting "a rule that permitted a COLI plan to be deemed mortality neutral only upon proof that 'every dime of mortality profit' is eliminated"); cf., *e.g.*, *id.* at 21a (Ryan, J., dissenting) (criticizing majority for "conclud[ing] that, as a matter of law, future profits contingent on taxpayer action are an appropriate component of the economic substance calculus *only* when that action comports with the taxpayer's actual past conduct"). Petitioner does not argue that the clear-error standard of review could meaningfully have been applied to the district court's resolution of those subsidiary legal questions.[5] *A forti-*

[5] As discussed above, on the former issue, the court of appeals held that a taxpayer's voluntary future investment should be discounted for

ori, it would have been incongruous for the court of appeals to have engaged in clear-error review of the district court's *ultimate* determination that the transactions at issue had economic substance, when that determination evidently rested on the district court's (erroneous) resolution of those subsidiary legal questions. Because the court of appeals did not pass on *any* subsidiary factual issues in reversing the district court's ultimate determination on economic substance, this case is an exceptionally weak candidate for application of a deferential standard of review.

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purposes of the economic-substance doctrine when it would represent a "drastic departure" from its previous conduct. Although petitioner repeatedly characterizes that holding as an "exclusionary rule" (Pet. 10, 11, 19, 20, 28, 29), petitioner does not contend that the court of appeals was resolving a question of fact rather than law. See, *e.g.*, Pet. 2 (asserting that the court of appeals "bar[red] consideration, as a matter of law, of the trial court's finding regarding [petitioner's] intended cash investments"); Pet. 19 (criticizing court of appeals for characterizing *Knetsch*, *supra*, as holding that, "in any economic substance inquiry, investment by the taxpayer that somehow departs from the taxpayer's actual prior conduct is irrelevant as a matter of law").

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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REPLY BRIEF

Supreme Court, U.S.
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JAN 2 3 2007
OFFICE OF THE CLERK

No. 06-478

IN THE

Supreme Court of the United States

THE DOW CHEMICAL COMPANY AND SUBSIDIARIES

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

REPLY TO BRIEF IN OPPOSITION

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RULE 29.6 STATEMENT

The Dow Chemical Company has no parent corporation, and there is no publicly held company owning 10% or more of its stock. It is the parent of the subsidiaries included within the consolidated group for tax purposes as of the date of this petition, and no other publicly held company owns 10% or more of the stock of any of those subsidiaries. Subsidiaries that were members of the consolidated group for tax purposes during the tax years at issue, but are no longer included in The Dow Chemical Company's consolidated tax group, are not financially interested in the outcome of this litigation.

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REPLY TO BRIEF IN OPPOSITION

Dow's petition presents two vital issues involving the economic substance doctrine on which the rulings by the panel majority below conflict with precedents of this Court and other circuits. The government seeks to perpetuate these conflicts for tactical advantage in other cases, and to defend the unwarranted outcome below, by mischaracterizing the majority's decision, the record, and the standards for a writ of certiorari. Recently, the Chief Counsel of the Internal Revenue Service ("IRS") has endorsed the importance of this case, as have members of the business community concerned about its substantial adverse impacts on *bona fide* business practices. *See* Br. *Amici Curiae* of the American Chemistry Council, U.S. Chamber of Commerce, and National Association of Manufacturers in Support of Petitioner ("Amici Br."). Review of both *Dow* issues is imperative.

A. EVENTS SINCE THE FILING OF DOW'S PETITION CONFIRM ITS EXTRAORDINARY IMPORTANCE

1. Recent public statements by the IRS – nowhere acknowledged by the government – explicitly attest to the importance of the *Dow* decision. As summarized in *Tax Notes Today*, in a series of speeches in October 2006, IRS Chief Counsel Donald Korb[1] discussed recent cases – starting, notably, with *Dow* – and "emphasized the importance of the courts' analyses." Sheryl Stratton, 113 Tax Notes (TA) 394 (Oct. 30, 2006). Korb "believes" that "[t]he principles from those cases will be cited 20 years from now . . ." *Id.* "[He said the] important principle to be taken from . . . [*Dow*] is that companies have to be able to show that they've engaged in a particular course of conduct before the transaction for a court to believe they are likely to do

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[1] The Chief Counsel represents the IRS in litigation and is the chief expositor for the IRS on all legal issues. *See* I.R.M. 1.1.6.1 (July 29, 2005) (Internal Revenue Manual).

something in the future . . . ." *Id.* Furthermore, "[Korb] acknowledged the U.S. Supreme Court may need to clarify controversial economic substance issues . . . ." Daily Tax Rep. (BNA) (Oct. 27, 2006), at GG-1. *Dow* is only the tip of the iceberg, as "Korb noted" economic substance cases "are coming down the pike . . . ." 113 Tax Notes (TA) 394.

2. Coltec Industries, Inc. has filed a separate certiorari petition involving the economic substance doctrine. *See Coltec Indus., Inc. v. United States*, No. 06-659 (Nov. 8, 2006). That petition seeks review of a Federal Circuit decision that repeatedly relies on *Dow* and is similarly applauded by the IRS. *See Coltec Indus., Inc. v. United States*, 454 F.3d 1340, 1355 & n.13, 1356 & n.15 (Fed. Cir. 2006), *discussed in, e.g.*, 113 Tax Notes (TA) 394. The first issue presented in both *Coltec* and *Dow* is *identical*: the correct standard for appellate review of economic substance determinations. The two petitions also have closely related second issues. Coltec asks the Court to determine the role of business purpose in judging a transaction's economic substance, while Dow asks the Court to confirm that all pertinent facts, including business purpose, are legally relevant in reaching that judgment. Thus, the *Coltec* decision and petition illustrate the increasing IRS focus on economic substance and the importance of Dow's petition.

B. THE FIRST QUESTION PRESENTED BY DOW WARRANTS THIS COURT'S REVIEW

1. The government concedes (at 17) that, in "at least some" of the decisions in the five circuits following the "clear error" standard of review, the courts "were deferring to the ultimate determination on economic substance" and not "merely to underlying factual determinations." In fact, any fair reading of the case law shows that the lower courts are in complete disarray on the standard for appellate review of the trial court's ultimate determination. *See* Pet. 13-16.

2. This circuit split merits this Court's attention. As demonstrated by numerous decisions cited in Dow's petition

(at 16-17) – including decisions in which the standard of review was the only issue addressed – this Court has routinely ruled on this question in other areas because of its importance to the administration of the law. The issue has great significance here, especially because it is intolerable to have taxpayers treated differently based solely on which circuit has jurisdiction over the appeal. Indeed, the government opposes certiorari to preserve its ability, at least in the several circuits where the issue is still open, to advocate the standard of review of its choice depending on whether it won or lost at trial – a practice that is antithetical to a fair and just legal system.[2] *See also* Pet. 18-19.

3. The government contends (at 16-17) that *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 n.16 (1978), establishes *de novo* review as the correct answer to the circuit split. But that contention ignores that the split is pervasive, has persisted long since *Frank Lyon* was handed down, and will not go away without this Court's intervention. In fact, the government itself has argued for deferential review despite *Frank Lyon*'s assertedly contrary holding.[3] Moreover, it is difficult to reconcile *de novo* review of factually based economic substance determinations with decisions such as *Comm'r v. Duberstein*, 363 U.S. 278, 290-92 (1947), and *Comm'r v. Heininger*, 320 U.S. 467, 475 (1943), where the Court called for deferential review of trial court determinations regarding "gift" and "ordinary and necessary business" expenses, respectively. *Frank Lyon* also

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[2] In *American Electric Power Co. v. United States*, 326 F.3d 737, 741 (6th Cir. 2003), *cert. denied*, 540 U.S. 1104 (2004), *Cashman v. United States*, 1991 U.S. App. LEXIS 8658, at *12 (9th Cir. 1991), *cert. denied*, 502 U.S. 1075 (1992), and *Newman v. Comm'r*, 902 F.2d 159, 162 (2d Cir. 1990), the government won at trial and then argued for clear error review. But in *Dow*, having lost at trial, the government argued for *de novo* review. *See* Gov't C.A. Br. 33.

[3] *See Rexnord, Inc. v. United States*, 940 F.2d 1094, 1096 (7th Cir. 1991), and cases cited in note 2 above.

largely predates this Court's articulation of general standard of review principles. Those principles argue strongly for deferential review of the trial court's determination that Dow's programs had "substantial [non-tax] effects on [its] beneficial interest." App. 153a; *see* Pet. 16-18.

4. The government also errs in arguing (at 18), without citation of any authority, that Dow did not preserve its right to contest the Sixth Circuit's standard of review ruling. An issue *is* preserved if *either* the court addressed the issue *or* the petitioner presented it below.[4] In this case, *both* bases for review have been satisfied. First, the Sixth Circuit expressly addressed the standard of review. *See* App. 9a & n.8. That by itself preserved the question, "particularly" because "the issue is . . . in a state of evolving definition and uncertainty, and one of importance to the administration of federal law." *Williams*, 504 U.S. at 41-42, *quoting Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1099 n.8 (1991) (citations and internal quotation marks omitted). Indeed, in *Lebron v. Nat'l Railroad Passenger Corp.*, 513 U.S. 374, 378-79 (1995) (alternative holding), the Court made clear that an issue may be raised so long as "it was addressed . . . below," *even if* the petitioner "disavowed" it in both lower courts.

Second, contrary to the government's selective quotation from Dow's brief below, Dow did not concede the issue. Rather, it vigorously argued that the correct standard of review is clear error, which is why the panel majority considered the question. A full reading of the pertinent portion of Dow's brief (*see* App. 214a & n.15) shows that all Dow did was to acknowledge that the debatable standard of review on the ultimate economic substance determination did not need – under the law as it then existed – to be decided

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[4] *See United States v. Williams*, 504 U.S. 36, 41 (1992) (emphasizing that "this rule operates . . . in the disjunctive"); *see also, e.g., Verizon Communications Inc. v. FCC*, 535 U.S. 467, 530 (2002) (exercising the Court's "broad discretion" to review "[a]ny issue 'pressed or passed upon below'").

where the government had simply challenged the district court's key factual findings as clear error. This was because, in Dow's words before the Sixth Circuit, under that law the "ultimate determination [on economic substance] follow[ed] directly from affirmance or reversal of" those findings – a point with which the dissenting judge below agreed (*see* App. 21a). Neither the circuit court nor the government was misled, as Dow expressly argued its side of the unsettled standard of review issue. In fact, if any party was misled, it was Dow, as the majority *sua sponte* changed the rules mid-game by inventing its exclusionary rule.[5]

5. Finally, despite the fact that the majority opinion below devoted significant attention to the standard of review, the government argues (at 19-20) that the majority's ruling was useless dictum because it "did not pass on *any* subsidiary factual issues in reversing the district court's ultimate determination on economic substance . . . ." The premise of this argument is false. The majority applied its novel exclusionary rule to the facts of the case itself rather than remand to the district court to do so, even though that court could easily have found that Dow's planned $30 million cash infusion in its Great West policies was *not* a drastic departure from the $60 million investment Dow actually made in the early years of that plan. *See* Pet. 29. The majority (App. 17a-20a) also reversed the district court's alternative holding that Dow's COLI programs had economic substance due to "risk transfer and the possibility of a mortality profit." App. 200a; *see* Pet. 11 n.4. The majority reasoned that the trial court had raised too "high" a "hurdle as a prerequisite to finding that Dow's plans were designed

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[5] Contrary to the government's claim (at 18 n.4), Dow also questioned the standard of review in its rehearing petition (at 14) by criticizing the panel majority's effort to legalize the determination of economic substance through adoption of the *de novo* standard. *See* App. A hereto at 2a. In addition, it specifically argued for deferential review in a Rule 28(j) letter in support of its petition. App. 217a-19a & n.1.

to neutralize mortality gains." App. 20a. But, again, the majority failed to remand to the trial court to determine whether Dow's programs offered a sufficient degree of potential mortality profit to imbue them with economic substance, even though they transferred substantially more mortality risk to the insurers than existed in the prior COLI cases.[6] Instead, the majority substituted its own judgment "that Dow would not significantly benefit from mortality gains." App. 20a. The majority's actions would have been impermissible under the clear error standard of review.[7]

C. THE SECOND QUESTION PRESENTED BY DOW WARRANTS THIS COURT'S REVIEW

1. The government concedes (at 19) that the majority below ruled as a matter of law on the permissibility of considering future cash investment by the taxpayer in assessing economic substance. But the government gravely mischaracterizes the majority's actual holding. Contrary to the government's repeated refrain (*see, e.g.*, (I), 9), the majority did not rule that "the possibility" that the taxpayer would make "uncharacteristically large [future] cash contributions" should be "discounted." Rather, the majority held that "future profits contingent on some future taxpayer action" that is "a drastic departure from . . . past conduct" must be totally "*ignored*" in judging economic substance – regardless of *"the likelihood of the investment"* based on

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[6] The trial judge, for example, specifically found that, even apart from the possibility of mortality profit from catastrophic loss, an 18% probability (almost double what MetLife considered appropriate) existed that death benefits would exceed the "stop-loss" limitation on mortality costs that MetLife could charge Dow. *See* App. 151a-52a. *Compare, e.g., American Electric Power Co.*, 326 F.3d at 743 (COLI program "*ensur[ed]*" that risk transfer to insurer, and hence potential for morality gain by policy owner, "*ceased to exist*") (emphasis added).

[7] *See, e.g., Duberstein*, 363 U.S. at 291-92; *United States v. Thomas*, 327 F.3d 253, 256-57 (3d Cir.), *cert. denied*, 540 U.S. 974 (2003); *see also, e.g., Pullman-Standard v. Swint*, 456 U.S. 273, 291-92 (1982).

"the taxpayer's plans" and its economic incentives arising from *"the profitability of the transaction."* App. 13a-15a & n.13 (emphasis added). By disregarding the italicized language, the government tries to paper over the broad sweep of the majority's ruling, its inconsistency with precedents of this Court and other circuits, and the havoc that it wreaks on everyday *bona fide* financial planning.

2. The government argues that the majority did not violate *Knetsch v. United States*, 364 U.S. 361 (1960), in excluding consideration of Dow's planned future cash investments because "[t]he better reading" of the *Knetsch* footnote on which the majority relied is that such exclusion is proper "when those contributions are 'wholly unlikely,' *as an objective matter*, in light of the taxpayer's previous conduct . . . ." Br. in Opp. 11-12 (emphasis added). This gloss is inconsistent with the rule that the majority actually adopted, which excluded *objective* evidence demonstrating "the likelihood of the investment" as a result of "the profitability of the transaction." *See* App. 14a n.13; *see also*, *e.g.*, Pet. 8 (factors (2)-(4)). More importantly, it ignores the fact that the majority established *an irrebuttable presumption* that taxpayers who enter into transactions contemplating large future cash contributions may not rely on those contributions to establish economic substance regardless of contrary proof – based on actual business plans and financial incentives – that the investments in fact will be made. The *Knetsch* footnote surely established no such presumption, as the dissent below showed and tax practitioners have concluded. *See* Amici Br. 3. To the contrary, as previously explained (Pet. 19-21), the ruling below defies *Knetsch*'s overarching premise that future profitability due to future taxpayer action *must be* considered in judging economic substance – which is exactly what the majority did not do.

3. The same sleight of hand in the government's treatment of *Knetsch* infects its discussion (at 13-15) of the other conflicting precedents cited by Dow (Pet. 21-27). In

fact, by conceding that this Court in *Frank Lyon* "credited the district court's finding that 'it was highly unlikely, as a practical matter, that any purchase option . . . would ever be exercised,'" the government admits that this Court does not indulge in arbitrary irrebuttable presumptions like the one erected by the majority below and, to the contrary, regards the likelihood of future cash contributions and other taxpayer action as highly relevant in determining economic substance. *Duberstein* likewise establishes that tax benefits may not be withheld based on "*overstatements* of possible evidentiary inferences relevant to a factual determination." 363 U.S. at 287 (emphasis added). The circuit court decisions cited by Dow similarly show that the taxpayer's plans and financial incentives must be consulted in assessing a transaction's economic substance. Thus, they establish a direct conflict with the ruling below.[8]

4. Finally, the government asserts (at 10, 15) that this case is "a poor vehicle" for consideration of the exclusionary ruling. But, contrary to the government's claim, reversal of that holding *would be* outcome-determinative. As explained in Dow's petition (at 11 n.4), but overlooked in the government's opposition, the generation of net cash value establishes economic substance under Sixth Circuit law regardless of the potential for mortality gain. Further, the

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[8] The government ignores the holding in *Bailey v. Comm'r*, 912 F.2d 44 (2d Cir. 1990), that projected cash expenditures could *not* simply be disregarded, even though they dwarfed the taxpayer's initial cash outlay. *See* Pet. 26. Moreover, contrary to the government's arguments (at 14-15), in *Shirar v. Comm'r*, 916 F.2d 1414, 1416, 1418 (9th Cir. 1990) (quotation at 1418), the court specifically distinguished *Knetsch* and upheld the economic substance of the insurance program on the ground that Shirar, who had previously relied on policy loans to pay premium and interest, "did not plan to borrow the entire increased cash value . . . on an annual basis." Here the district court also found that Dow did not intend to continue borrowing cash value. *See* Pet. 8. Also like Shirar, Dow had legitimate costs to fund (*see* Pet. 5) and purchased real insurance to do so. *See, e.g.*, note 6 above.

government's prospect for success on other remaining issues is remote, as shown by the dissent's cogent rejection of them. App. 25a-27a, 31a-33a. In any event, the government's insistence (at 11) that an issue be "clearly outcome-dispositive" to justify review overlooks what this Court's frequent remands for consideration of other issues document: the Court withholds certiorari where an issue is "*irrelevant* to the ultimate outcome," but grants review where the issue appears to have a potential effect on the outcome and thus presents a case or controversy. *See* Robert L. Stern, *et al.*, SUPREME COURT PRACTICE 231 (8th ed. 2002) (emphasis added). That test is more than satisfied here.

The government's attempt (at 15) to relegate this case to "a context of little if any prospective importance" is similarly unfounded. The majority's exclusionary ruling already has left companies in such a quandary about the tax consequences of many important capital financing strategies having nothing to do with COLI that leading business associations have called for its prompt correction. Amici Br. 9. Moreover, the government disingenuously states (at 15) that it knows "of only one other pending case concerning the application of the economic-substance doctrine to . . . 'broad-based' COLI plans." While acknowledging that *post-1986* "broad-based" programs were being settled, the government itself advised the court below in a verified statement that *Dow* is "of *vital* importance in resolving the deductibility of the tax benefits claimed for *pre-1986* COLI programs" and that those programs "are expected to have a monetary impact *even exceeding* the $4 billion dollar fiscal effect of *post-1986* broad based COLI plans."[9] This impact confirms the pressing need for review of both rulings below,

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[9] United States' Motion for Reconsideration of Order Denying Its Motion for Expansion of Word Limit, 6th Cir. No. 03-2360, at 2-3 (Nov. 19, 2003) (emphasis added) (excerpted in App. B hereto; *see* p. 4a). The 1996 legislation cited by the government (at 15) grand-fathered all pre-1986 policies for continued favorable tax treatment. *See* Pet. 4.

even apart from the effect on other business practices.

Finally, the government suggests (at 15) that the Court defer review until another circuit rejects the majority's exclusionary rule. As *amici* explain, the need for review is urgent because the rule *currently* has substantial adverse effects on business planning, and, as explained in Point A.1. above, the IRS has now pledged to enforce a broad reading of the rule. Moreover, the rule's conflicts with other decisions already are manifest, as are its legal errors that the government does not even attempt to address.[10] It suffices for certiorari that "the court of appeals has allegedly misconstrued, misapplied, or misconceived an applicable Supreme Court opinion . . . ." Stern, *supra,* at 233. As the parties' disagreement on the meaning of the *Knetsch* footnote shows, and the dissent below confirms, that test is plainly met here.

CONCLUSION

Dow's petition for a writ of certiorari should be granted. If review is granted, Dow is prepared to comply with a briefing schedule shortened to permit argument this Term.[11]

Respectfully submitted,

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[10] The government, for example, offers no defense of the majority's irrebuttable presumption or exclusion of evidence critical to establish the very terms of the transaction to be reviewed. *See* Pet. 27-30.

[11] The Court may wish to grant review in both *Dow* and *Coltec* and hear the cases in tandem. This would enable a broader array of issues to be addressed. Despite the cases' substantial overlap, *Coltec* does not deal directly with the exclusionary rule raised in the *Dow* petition, while *Dow* does not directly address the circuit split on the test for economic substance raised in the *Coltec* petition (at 18-22). In tandem consideration of the two cases also would deepen the Court's understanding of all the issues presented because of different factual contexts and interdependent legal principles. *See* Point A.2. above. Further, Dow would be entitled to application in its favor of any ruling that calls into question the "disjunctive" test for economic substance applied by the panel below (*see* App. 8a).

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APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 03-2360

THE DOW CHEMICAL COMPANY
AND SUBSIDIARIES,
Plaintiff-Appellee,

v.

UNITED STATES OF AMERICA,
Defendant-Appellant.

ON APPEAL FROM THE JUDGMENT OF THE
UNITED STATES DISTRICT COURT FOR THE
EASTERN DISTRICT OF MICHIGAN

PETITION FOR REHEARING WITH SUGGESTION FOR REHEARING
EN BANC

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Beyond this, the majority's rulings reverse the proper relationship between appellate and trial courts. Appellate courts are supposed to defer to trial judges in assessing the evidence. *Anderson v. City of Bessemer*, 470 U.S. 564, 574-75 (1985). Historically, this Circuit observed this division of labor so scrupulously that even the ultimate judgment on economic substance – itself at bottom a factual determination – was reviewable only under the "clearly erroneous" test. *Ratliff v. Comm'r*, 865 F.2d 97, 98-99 (6th Cir. 1989), *adopting Yosha v. Comm'r*, 861 F.2d 494, 499 (7th Cir. 1988). But now, concluding that the standard of review has become *de novo* (*see* Slip op. at 5 n.8), the majority embarked on "legalizing" the determination of economic substance through the development of judge-made rules that second-guess and supersede the trial court's factual findings. This will invite argument for more such rules and embroil this Court in factual disputes that should be decided in the district court on individual merit based on all relevant evidence.

* * *

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 03-2360

UNITED STATES OF AMERICA,
Appellant,

v.

THE DOW CHEMICAL COMPANY
AND SUBSIDIARIES,
Appellee.

ON APPEAL FROM THE JUDGMENT OF THE
UNITED STATES DISTRICT COURT FOR THE
EASTERN DISTRICT OF MICHIGAN

UNITED STATES' MOTION FOR RECONSIDERATION OF ORDER
DENYING ITS MOTION FOR EXPANSION OF WORD LIMIT

[Received]
[Nov 20 2003]
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* * *

2. This case is of critical importance to the resolution of other COLI cases and will have a major impact on the federal fisc. The tax impact of this case for suit and non-suit years is over $100 million. Moreover, this case has significance for other broad based COLI programs. Contrary to Dow's claim that all but five of the broad based COLI cases pending at the administrative level have settled (Op. at 2), settlement in some of these cases with a substantial monetary impact has not yet been finalized. Some, if not many, of those taxpayers could decide to rescind their non-binding elections to settle depending on the outcome of this appeal. Further, this case is also of vital importance in resolving the deductibility of the tax benefits claimed for pre-1986 COLI programs. *See*, TAM 200213010, 2002 TNT 62-19. (IRS recently stated that the economic sham doctrine is equally applicable to disallow deductions attributable to highly leveraged COLI programs purchased prior to June 20, 1986. This was the effective date of the $50,000 per policy loan limitation of Section 264 (a)(4)(1986), which spawned the advent of broad based COLI programs as at issue in the instant case.) The open and future tax years for pre-1986 COLI programs are expected to have a monetary impact even exceeding the $4 billion dollar fiscal effect of post-1986 broad based COLI plans.

* * *

IN THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

UNITED STATES OF AMERICA,	)	
	)	
Appellant	)	
v.	)	No. 03-2360
	)	
THE DOW CHEMICAL CO.	)	
& SUBSIDIARIES	)	
Appellee	)	

DECLARATION

Dennis M. Donohue of the Tax Division of the Department of Justice, Washington, D.C., states as follows:

1. I am an attorney employed in the Tax Division of the Department of Justice, and, in that capacity, I have been assigned the primary responsibility for handling the above-entitled case on behalf of the United States.

2. The facts set forth in the accompanying **United States' Motion For Reconsideration of Order Denying Its Motion For Expansion of Word Limit** are true to the best of my knowledge and belief.

I declare under penalty of perjury pursuant to 28 U.S.C. Section 1746 that the foregoing is true and correct. Executed this 19th day of November, 2003, at Washington D.C.

/s/ Dennis M. Donohue
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No. 06-478

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IN THE

Supreme Court of the United States

THE DOW CHEMICAL COMPANY AND SUBSIDIARIES,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

BRIEF *AMICI CURIAE* OF THE AMERICAN CHEMISTRY COUNCIL, THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, AND THE NATIONAL ASSOCIATION OF MANUFACTURERS IN SUPPORT OF PETITIONER

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QUESTIONS PRESENTED

1. Whether the Sixth Circuit erred by holding, in direct conflict with at least five circuits (but in accord with at least two others) that the trial court's determination on economic substance is subject to *de novo* review.

2. Whether the Sixth Circuit erred by creating, in direct conflict with the decisions of this Court and other circuits, an exclusionary rule for economic substance cases that bars consideration of future taxpayer investment merely because the taxpayer has engaged in a long-term transaction in which a substantial portion of its out-of-pocket expenditure is deferred.

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INTEREST OF *AMICI CURIAE* [1]

The American Chemistry Council ("ACC") represents the leading companies engaged in the business of chemistry, a $550 billion enterprise and a key element in the nation's economy. ACC members apply the science of chemistry to make innovative products and services that make the lives of people throughout the country and abroad better, safer and healthier. The ACC supports these endeavors by, among other things, filing *amicus curiae* briefs in matters of importance to this critical sector of the economy.

The Chamber of Commerce of the United States of America ("Chamber") is the nation's largest federation of business companies and associations. It represents an underlying membership of more than three million business, trade and professional organizations of every size, sector and geographic region of the country. One of the Chamber's primary missions is to represent the interests of its members by filing *amicus curiae* briefs in cases involving issues of national importance to American business.

The National Association of Manufacturers ("NAM") is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing in America's economic future and living standards. In support

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[1] Pursuant to Supreme Court Rule 37.6, *amici* state that the brief was authored in its entirety by *amici curiae* and their counsel. No monetary contribution toward the preparation or submission of this brief was made by any person other than *amici curiae*, their members and their counsel. By letters filed with the Clerk of the Court, petitioner and respondent have consented to the filing of this brief.

of this mission, the NAM regularly files briefs *amicus curiae* in this Court and other courts.

While *amici* do not themselves own corporate-owned life insurance policies and take no position with respect to them, *amici* have a compelling interest is ensuring that their member companies receive clear guidance from this Court about the nature of acceptable corporate finance structures under the tax code. These include economically sound, frequently used investment and financing tools in which companies defer some payment on an obligation. The Sixth Circuit's decision—both for the rule it announces and the uncertainty it creates—forces companies to reconsider those strategies, which can increase the cost of capital and hurt the bottom line of America's businesses. To vindicate those important business interests, *amici*, of whom petitioner is a member, respectfully submit this brief.

SUMMARY OF THE ARGUMENT

This case raises questions of great importance to the business community in the United States. *Every* deduction or credit claimed by a company filing a tax return in the United States must satisfy at least two requirements. First, it must comply with the technical requirements of the Internal Revenue Code. Second, the transaction giving rise to the claimed deduction or credit must have "economic substance." Due to the ubiquity of the "economic substance" doctrine, businesses heed its precise contours. Even slight changes in the doctrine affect the tax treatment of countless transactions and, consequently, influence business decisions about how to raise, allocate and reallocate capital. *See* Joseph Bankman, *The Economic Substance Doctrine*, 74 S. Cal. L. Rev. 5, 6 (2000) ("[T]he economic substance doctrine has been used to deny tax benefits aggregating to many billions of dollars.").

In this case, the Sixth Circuit's split decision could work a monumental shift in the operation of the "economic substance" doctrine and, consequently, affect corporate capital

financing strategies. Critically, the majority held that evidence of a transaction's eventual profitability *must be excluded as a matter of law* where that profitability depended on optional future capital infusions "seriously depart[ing]" from the taxpayer's past conduct. (Pet. App. 13a) The *only* authority cited for this sweeping exclusionary rule was a footnote from *Knetsch v. United States*, 364 U.S. 361, 366 n. 3 (1960). In doing so, as the dissenting judge explained, the majority "read into *Knetsch* far more than the Supreme Court wrote in that case . . . ." (Pet App. 22a). *See also* Crystal Tandon & Sheryl Stratton, *Korb, Former IRS Officials Discuss Recent Shelter Cases*, 112 Tax Notes 1113 (Sept. 25, 2006) (characterizing one tax practitioner's view of decision below as follows: "The Sixth Circuit's view in no way follows from the *Knetsch* case on which it relied."). Not only did the majority depart from this Court's past decisions, it also parted company with its sister circuits. As one respected tax commentator recently noted, the majority "interpreted *Knetsch* . . . in a manner in which no court had interpreted that case before." Richard M. Lipton, *What Will be the Long-Term Impact of the Sixth Circuit's Divided Decision in* Dow Chemical, 104 J. Taxation 332, 337 (2006). The decision below therefore "means that all of the settled wisdom concerning the meaning of [*Knetsch*] is now called into question." *Id.* Just recently, the IRS's Chief Counsel recognized the potential need for this Court's guidance on the economic substance doctrine in light of decisions like the one below. *See Korb Acknowledges U.S. Supreme Court May Need to Clarify Economic Substance*, Daily Tax Rep. (BNA) (Oct. 27, 2006).

The implications of this novel and unprecedented interpretation of *Knetsch* are potentially quite sweeping. A variety of widely used, well accepted and economically sound corporate finance structures rely precisely on discretionary future capital infusions by the taxpayer. The Sixth Circuit's categorical exclusion of such evidence complicates the future use

of such structures. Not only does the Sixth Circuit's exclusionary rule hamper companies' efforts to justify their programs in "economic substance" disputes with the Government, more importantly it forces risk-averse companies to modify or, yet worse, abandon these important financing schemes precisely to avoid such time-consuming and costly disputes.

Just as the Sixth Circuit's reshaping of the economic substance doctrine warrants *certiorari*, so too does its holding regarding the proper standard of review. *Amici* agree with petitioner that the Sixth Circuit's decision to review economic substance determinations *de novo* further deepens a mature split among the federal courts of appeals over this question. That issue is of critical importance to the American business community, for, in recent years, it has consistently benefited the Government, not the taxpayer, on appeal. This case presents the ideal vehicle in which to resolve the split on this important issue—the Court has a fully developed factual record, and this is one of those exceptional cases in which the standard of review truly is outcome determinative.

In sum, in addition to the reasons offered in Dow's petition, granting a writ of *certiorari* is necessary to address the issues of great importance to the American business community implicated by the decision below.

ARGUMENT

I. *CERTIORARI* SHOULD BE GRANTED TO ADDRESS THE IMPORTANT IMPLICATIONS OF THE SIXTH CIRCUIT'S DECISION FOR A VARIETY OF ECONOMICALLY SOUND TRANSACTIONS THAT DEPEND ON FUTURE PAYMENTS BY THE TAXPAYER.

A. The Sixth Circuit's Fuzzy Exclusionary Rule Calls Into Doubt a Substantial Number of Important Corporate Finance Transactions, the Economic Rationale of which Depends on Future Payments by the Taxpayer.

This case concerns relatively simple, but extremely important, principles of corporate finance. Every day, American businesses must make purchasing decisions and financing decisions. In this case, for example, petitioner had to decide how to cover its retirees' benefits several decades in the future while not encumbering too much of its capital until those obligations became due. That purchasing decision is not unlike ones that American businesses make every day – whether to buy a piece of equipment, lease an office building or buy another company.

Equally important as the purchasing decisions are financing decisions, which are at the core of this case. A company may take out a loan (perhaps with a deferred payment schedule or a balloon payment). It may choose to sell certain assets (and, thereafter, lease them back). It may choose to leverage its assets (akin to a mortgage). It may choose to invest a stream of capital (either from its existing capital reserves or from borrowed funds). These choices will depend on, among other things, how much money the company has, how much it requires, how much it projects having at future points in time, the state of the capital markets and the cost of the various options.

In addition to these considerations, the choices will also depend on the tax implications. As this Court has long recognized, "[w]e cannot ignore the reality that the tax laws affect the shape of nearly every business transaction." *Frank Lyon Company v. United States*, 435 U.S. 561, 580 (1978); *Commissioner of Internal Revenue v. Brown*, 380 U.S. 563, 579-580 (1965) (Harlan, J., concurring). *See also* Pet. App. 27a (Ryan, J., dissenting) ("[C]orporations operate in a world with taxes and . . . some investments are tax favored."). The form of a transaction (*e.g.*, whether to borrow money, sell an asset, mortgage an asset or raise capital) can dramatically affect its treatment under the tax code and, consequently, affect its overall cost.

Of course, under this Court's precedents, a taxpayer is not entitled to every claimed deduction. The judicially created "economic substance" doctrine bars a taxpayer from receiving a deduction or claiming a credit where a transaction lacks "any practicable economic effects other than the creation of income tax losses." 4 Mertens, *Law of Federal Income Taxation* §22.31 at 85 (Cum. Supp. 2006). Critically, this doctrine applies to *any* transaction giving rise to a deduction or credit. *See Lerman v. Commissioner*, 939 F.2d 44, 52 (3d Cir. 1991) (citing *Gregory v. Helvering*, 293 U.S. 465 (1935)). Consequently, judicial modifications of the doctrine have the potential to affect a virtually limitless array of transactions giving rise to deductions, not just the particular transaction before the court. *See generally* David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Law. 235, 241 (1999); Bankman, 74 S. Cal. L. Rev. at 29.

The Sixth Circuit's decision represents such a modification with sweeping implications. This is the critical portion of the decision:

> Courts may consider future profits contingent on some future taxpayer action, but only when that action is consistent with the taxpayer's actual past conduct. Courts should be skeptical, however, when the asserted future

> profits hinge on future taxpayer action that seriously departs from past conduct, especially where such departure involves the expenditure of large sums of money. (Pet. App. 13a) (footnote omitted).

As Judge Ryan correctly explained in dissent, "there is no such precedential rule of law and no warrant for creating one in this case." (*Id.* at 21a). The majority cites no authority for this newly minted rule of evidence apart from a footnote in *Knetsch v. United States*, 364 U.S. 361, 366 n. 3 (1960), which, as Dow explains (Pet. 20-21), the majority misreads. *See also* Lipton, 104 J. Taxation at 337 ("The majority [in the decision below] appeared to create a legal requirement based on *Knetsch* out of thin air . . . .").

This gross departure from this Court's precedents alone warrants *certiorari*, if not summary reversal. Apart from this deviation from settled law, the decision below also warrants this Court's review due to the importance of this newly minted "exclusionary rule" for the nation's business community. The sections that follow explain the impact of that rule on the capital financing choices that businesses must make.

1. *The decision below fails to provide the clarity that businesses need to make capital financing decisions.*

This Court repeatedly has emphasized the importance of clarity in the nation's tax laws. *See, e.g., Department of Revenue of Oregon v. ACF Indus., Inc.*, 510 U.S. 332, 344 (1994); *Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214, 223 (1992). Clear rules enable businesses to adopt capital financing strategies qualifying for favorable treatment under the nation's tax laws. They are especially important in the economic substance context for, as noted above, the doctrine bears on any claimed deduction or credit under the Internal Revenue Code. Yet, in three interrelated ways, the Sixth Circuit's rule undermines the necessary clarity that businesses require.

First, the decision below offers absolutely no guidance on the scope of the taxpayer's "past conduct." Is the relevant "conduct" only the taxpayer's conduct in the contested transaction? Does it encompass "conduct" in similar transactions? In all prior transactions? How is a new company, which may literally have no "past conduct" and yet may be precisely the company needing to engage in a prospective payment transaction, supposed to establish its entitlement to introduce evidence of the economic substance of the transaction? Clear answers to these questions are critically important. They enable a company to determine whether a particular capital financing strategy runs afoul of the Sixth Circuit's rule. Moreover, as explained in further detail below, *infra* at 17, they also may determine the scope of discovery that the Government can seek from a company in a contested transaction. Despite their importance, however, the decision below offers no guidance to businesses on these critical questions.

Second, even if the domain of evidence relevant to the "past conduct" inquiry could be established with any clarity, the decision below likewise is wholly opaque on what constitutes a "departure" from past conduct, much less a "serious" one. What if the taxpayer has had ten prior transactions with prospective payments and made the payments in nine cases? Eight? What is the minimum number? Is it absolute? Is it relative to the number of total transactions? What if the taxpayer is a new company and, by definition, has no "past conduct" from which a "departure" can be measured? Again, the American business community searches the Sixth Circuit's decision in vain for answers.

Third, even if the foregoing two hurdles can be overcome, what are we to make of the loose language at the end of the holding indicating that courts should be "especially" skeptical where a departure "involves the expenditure of large sums of money?" What does the Sixth Circuit mean by this last phrase? Is $1 million a large sum? $10 million? $100 million? Is it an absolute term? One relative to the com-

pany's balance sheet? Here too, the decision below offers no clarity and thus hinders predictability.

The lack of answers to these critical questions highlights the importance of the questions presented by this case. Unless the decision below is corrected *promptly*, companies are left to guess about its scope and, consequently, its impact on a variety of economically sound, frequently used capital financing strategies. As one tax practitioner recently explained, the decision below "threaten[s] the tax legitimacy of many transactions that . . . take time and more than one contribution of cash to generate profits. . . ." Tandon & Stratton, 112 Tax Notes at 1113. The following subsections describe some of those transactions and demonstrates how the Sixth Circuit's decision undermines their security.

2. *A substantial number of corporate finance transactions depend on future discretionary conduct by the taxpayer.*

In the Sixth Circuit's view, the critical flaw in Dow's transaction was that its profitability depended on optional future cash contributions by Dow. Pet. App. 13a. Despite the strong economic incentive for Dow to make these future contributions, the Sixth Circuit decided simply to ignore them in its economic substance analysis.

While the Sixth Circuit applied this rule in the particular context of corporate-owned life insurance policies, it has far broader implications. A variety of economically sound, frequently used capital financing strategies—including ones previously approved by this Court, other courts and the IRS—also rely on future discretionary or optional activity by the taxpayer. While space constraints do not permit an exhaustive review of all the transactions affected by the Sixth Circuit's rule, *amici* highlight several important ones here:

Options and Forward Contracts: Companies routinely issue instruments that entitle the holder to shares of stock at some future point in time. Depending on the circumstances, those

instruments may be characterized as "options," "forward contracts," "secured financing" arrangements, or "current sales." The characterization has critical tax consequences for both the issuing company and the instrument holder. For example, a put option may be recharacterized as a contract for sale; the effect of that recharacterization may be to disallow certain capital losses. *See* Rev. Rul. 85-87, 1985-1 C.B. 268. To decide whether to recharacterize the option, a long line of authority has instructed that the relevant considerations include whether there is a "substantial likelihood" that the option will be exercised. *See, e.g.*, Rev. Rul. 85-87, 1985-1 C.B. 268; Rev. Rul. 82-150, 1982-2 C.B. 110.

The Sixth Circuit's decision conflicts with this approach. Under the logic of the decision below, a court (and the IRS) would have to ignore the "substantial likelihood" that the option would be exercised. Instead, because the option, just like Dow's premium payments, depends on contingent future taxpayer conduct, a court would have to treat the instrument as if it were an unexercised option (unless the taxpayer could point to "prior conduct").

More importantly, companies and individuals might abandon a transaction altogether due to uncertainty over how to predict the transaction's characterization. In this setting, open questions over the meaning of "prior conduct" in the Sixth Circuit's rule have real bite. Would it suffice for the taxpayer to show that it had exercised options in *any* prior transaction? Or would the transaction have to be identical to the one under review? Given the centrality of "prior conduct" to the inquiry, the characterization of the transaction could well vary from taxpayer to taxpayer. For example, in the case of a taxpayer who has an established history of exercising an option, the instrument might be characterized as a "current sale." By contrast, in the case of a taxpayer who lacks such a history, a court (and the IRS) would have to treat precisely the same instrument as an unexercised option. The shifting

characterization of the same instrument would render their use virtually unworkable in the marketplace.

Sale/leaseback with a repurchase option: A sale/leaseback is another frequently used capital financing device depending on future conduct by the taxpayer. *See generally* Note, *Sale-Leasebacks: A Search for Economic Substance*, 61 Ind. L.J. 721 (1985/1986). Under the standard sale/leaseback, the company needing the capital sells an asset to another company. The buyer then leases the asset back to the seller. In some cases, the sale/leaseback may include repurchase options. The seller/lessee may have a "call option" under which it may repurchase the relevant asset at a set price; additionally, the buyer/lessor may have a "put option" under which it may sell the relevant asset at a set price.

This transaction yields substantial economic benefits for both parties. From the seller's perspective, the transaction provides an immediate front-end infusion of capital. It may enable the seller to realize 100% of the capital value of the sold asset at the beginning of the transaction, something that makes this transaction particularly important to companies in capital-intensive industries. The seller may use this infusion of capital to finance its operations and generate downstream income without the need to assume debt. From the buyer's perspective, the transaction provides a stream of future income in the form of lease payments.

Apart from its economic benefits, this transaction also has tax benefits. The seller generally can deduct the lease payments from its taxes. *See* 1 Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders §4.01[5] (Cum. Supp. 2006). Depending on the asset's value and the seller's basis, the seller also may be able to time the transaction to generate a capital loss and, thereby, offset other capital gains. *See id.* §5.03[3]. The "option" feature also enables the seller/lessor to take advantage of future depreciation once it regains ownership of the asset following the option's exercise.

This Court and others previously have approved true sale/leasebacks (including those with optionality features) as a capital financing structure. *See Frank Lyon*, 435 U.S. at 583-84; *American Realty Trust v. United States*, 498 F.2d 1194, 1198 (4th Cir. 1974). As with the above-described forward contracts, however, the characterization of the transaction can have critical tax consequences. For example, the sale/leaseback might be recharacterized as a type of "financing" or "loan" secured by the property, which can affect a taxpayer's ability to claim depreciation deductions. *See Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252 (1939). Alternatively, the put/call option (whether or not contained in a sale/leaseback) may be recharacterized as a sale, which can also affect a party's ability to claim certain depreciation or interest deductions. *Compare Kwiat v. Commissioner*, T.C. Memo 1992-433, 64 T.C.M. (CCH) 327 (recharacterizing lease with reciprocal put/call options as sale), *with Penn-Dixie Steel Corp. v. Commissioner*, 69 T.C. 837 (1978) (declining to recharacterize transaction with reciprocal put/call options as sale) and *Griffin Paper Corp. v. Commissioner*, T.C. Memo 1997-409, 74 T.C.M. (CCH) 559 (distinguishing *Kwiat* and declining to recharacterize reciprocal put/call options as immediate sale). In this context, a critical question in determining the proper characterization is the likelihood that the option will be exercised at the date of inception.

Again, the Sixth Circuit's analysis is inconsistent with this emphasis on the parties' economic incentives. For example, the exercise of the "option" in a sale/leaseback (or any transaction with a reciprocal put/call option), just like the future premium payments in Dow, depends on future conduct by the taxpayer. Even though at least one party may have a powerful economic incentive to exercise the option, that incentive does not suffice under the Sixth Circuit's rule. Unless the taxpayer can point to a conformity between the option's exercise and its own prior conduct, the "option" feature *must* be ignored for tax purposes.

Forward contracts and sale/leasebacks with an optionality feature represent just some of the myriad transactions called into doubt by the decision below. While page limits prevent complete discussion of other affected transactions, briefly they include

- *Sale with Repurchase Option*: This transaction resembles the above-described sale-leaseback except it lacks the lease feature. In this type of transaction, questions again arise over how to characterize ownership of the asset in light of the original seller's likelihood of repurchasing the asset in the future. If exercise of the option is virtually inevitable, then the sale might be effectively ignored, and the transaction recharacterized as a short-term "loan" from the buyer to the seller. In that case, the difference between the original sale price and the repurchase price may be treated as potentially taxable "interest income" to the buyer. In determining how to characterize such a transaction (whether as a sale with an option or a loan), this Court and others have focused on the economic realities of the transaction and the parties' incentives. *See, e.g., Nebraska Dep't of Revenue v. Lowenstein*, 513 U.S. 123 (1994); *Comtel Corp. v. Commissioner*, 376 F.2d 791 (2d Cir. 1967). Yet under the Sixth Circuit's rule, a court would have to ignore the "option" feature (for it would depend on contingent future action by the taxpayer) and instead treat the transaction as a sale with completely different tax consequences.

- *Forward Purchase Contract/Note Units*: In Revenue Ruling 2003-97, the IRS was asked to offer an opinion on whether a corporation could deduct interest in a complex transaction involving investment units. In the transaction, the company issues a two-part instrument: one part is a forward-purchase contract under which the contract holder agrees to buy a quantity of the company's stock in the future; the other part is a note, a basic debt instrument used to raise capital.

> The company initially issues the purchase contract and the note as a single unit, but, depending on the circumstances, the buyer has the option to split the unit and remarket it. Tellingly, the IRS indicated that the Code permits the interest deduction under certain circumstances. *See* Rev. Rul. 2003-97, 2003-2 C.B. 380. A "critical factor" for the IRS was the "substantial[] certain[ty] that the remarketing of the Notes [would] succeed." *Id.*. Under the Sixth Circuit's rule, though, that factor might be irrelevant. As with the premium payments in Dow, this facet of the transaction depends on future conduct. Of course, unlike Dow, the future conduct here is that of the noteholder, not the taxpayer (*i.e.*, the company seeking the interest deduction). Whether that distinction ultimately matters to the Sixth Circuit is unclear—which is precisely why the Sixth Circuit's decision is so dangerous. As with the other above-described transactions, that uncertainty may discourage parties from undertaking an economically desirable transaction.

In sum, the decision below calls into doubt these and other economically sound transactions that depend on future discretionary activity by the taxpayer.

3. *The "contract" exception to the Sixth Circuit's exclusionary rule is incoherent in theory, is ignored by the Government in practice and, therefore, calls into doubt an even broader array of transactions.*

The Sixth Circuit attempts to hedge the impact of its exclusionary rule in a footnote. There, the court states:

> [I]f a taxpayer were *contractually obligated* to infuse additional cash into an investment at some point in the future, such spending would not constitute a serious departure from past conduct that should be disregarded under *Knetsch*. Instead, the eventual outlay would be consistent with actual past conduct, i.e., the obligation

> that existed all along. (Pet. App. 15a, n. 14) (first emphasis added).

This purported limitation makes no sense. For one thing, the court does not explain *why* a contractual obligation establishes that future payments do not substantially depart from past conduct. By their very nature, contracts are obligations made in the present time to undertake some action *in the future*. *See Franconia Assocs. v. United States*, 536 U.S. 129, 142 (2002). It therefore is hard to see how such a future obligation can shed light on past conduct.

For another thing, contracts are not necessarily ironclad guarantees of future performance. They ultimately depend on the willingness of the contracting parties to honor their obligations and, reciprocally, enforce their rights. For example, a parent company may enter into a contractual obligation with its subsidiary. Even though the parties technically may have a contractual obligation, they may have actual little incentive ultimately to perform that obligation. Under the Sixth Circuit's decision, it is unclear whether a court would honor the form of the transaction (because obligations have been reduced to contract) or would create yet a further "exception to the contract exception" where the contractual obligation is illusory.

Finally, the Government itself has refused to recognize this limit on the Sixth Circuit's rule. In a recent case, the Government argued that "the creation of binding obligations between parties is *insufficient* to create economic substance for federal tax purposes." Memorandum of the United States in Support of Second Motion for Summary Judgment in *Xcel Energy, Inc. v. United States*, No. 04-CV-1449-PJS-RLR (D. Minn. Aug. 18, 2006), *available at* 2006 WL 2727375 (emphasis added). Similarly, the Chief Counsel of the IRS described the decision below in terms that gave no significance to the contract exception. Sheryl Stratton, *Korb Praises, Practitioners Question Enforcement Shift*, 113 Tax Notes 394 (Oct. 30, 2006). Thus, even companies that

attempt to avoid the harsh implications of the decision below through contracts have absolutely no assurance that such strategies will avoid costly and burdensome litigation by the Government.

Once the contract exception breaks down in theory—or, more importantly, is ignored by the Government in practice—then an ever wider array of transactions are open to doubt, including ones explicitly approved by other courts:

- *Partnership transactions using full recourse notes*: Individuals or companies may form partnerships to invest in certain assets. Partners may make their capital contribution over time according to a schedule, and the partnership may or may not have recourse against the partner in case of non-payment. *Smith v. Commissioner* involved a case where the partnership generated a loss, and a partner sought to deduct its share of the losses even though it had not paid its contribution in full. 937 F.2d 1089 (6th Cir. 1991). Here, as in the case below, the transaction depended on future action by the taxpayer (namely the unpaid contributions). The Sixth Circuit approved the deduction, yet, if the Government refuses to recognize the contract exception, it might challenge the types of deductions allowed in *Smith*.
- *Foreign subsidiaries*: Companies often establish foreign subsidiaries or entities as a means of either raising capital or insuring against liabilities. *See United Parcel Serv. of Am., Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001); *Northern Indiana Pub. Serv. Co. v. Commissioner* ("*NIPSCO*"), 115 F.3d 506, (7th Cir. 1997). For example, in *NIPSCO*, a domestic company had trouble raising money in domestic capital markets due to high interest rates. It established a foreign subsidiary that raised funds from foreign borrowers and lent those funds to the domestic parent. The parent repaid the funds over a payment schedule and sought to deduct the accrued interest payments. Here too, the transaction depended on

> future conduct by the taxpayer. The Seventh Circuit allowed the deduction. Yet if the Government views the contractual obligation between the parent and subsidiary as illusory, then it may seek to disallow the sorts of interest payments allowed in *NIPSCO*.

In sum, given the instability of the "contract" exception and the Government's public position, the decision below calls into doubt an even wider array of capital financing strategies. The next section explains how the insecurity created by the decision below over the enforceability of these transactions will affect actual business practices.

B. The Sixth Circuit's Exclusionary Rule Undermines Fairness in Tax Litigation, Skews Settlement with the Government and Impairs Economically Sound Corporate Finance Practices.

The practical impact of the Sixth Circuit's exclusionary rule on the transactions described above is threefold.

First, the Sixth Circuit's exclusionary rule affects the future of tax litigation with the Government. By excluding evidence of certain contingent future payments from its economic analysis, the decision prevents companies from fully justifying those capital financing tools detailed in Part A, *supra*. Moreover, by connecting the economic substance doctrine to a taxpayer's past conduct, the Sixth Circuit's rule invites fishing expeditions by the Government to probe the taxpayer's business records for years prior to those in dispute. Indeed, the Government already has been citing the decision below in an effort to justify such discovery. *See* Letter of May 19, 2006 from Nathaniel J. Dorfman, U. S. Dep't of Justice, to Judge Timothy S. Hogan, in *Procter & Gamble v. United States* (No. 1:05-CV-00355-MHW) (S.D. Ohio May 25, 2006), *available at*, 2006 WL 1985805.

Second, the decision below does not simply affect cases that result in litigation but also affects a larger number of cases that never reach litigation and are never reported. Like

any governmental agency with investigative powers, the Internal Revenue Service obviously seeks—and prefers—to settle cases rather than invest the resources required by litigation. *See* I.R.S. Manual 31.1.1.1.3 (4), available at *http:// www.irs.gov/irm/part31/ch01s01.html)*; Note, *Using Negotiation, Mediation and Arbitration to Resolve IRS-Taxpayer Disputes*, 19 Ohio St. J. Disp. Res. 709, 709 n. 5 (2004). The dynamics of those settlement discussions turn critically on the parties' expectations about a trial's likely course. The decision below unfairly strengthens the Government's hand by allowing it to argue at the settlement stage that various economic justifications for a capital financing decision are immaterial because the supporting evidence would be inadmissible. *See* Yoram Keinan, *The COLI Cases Through the Looking Glass of the Sham Transaction Doctrine*, 31 Ins. Tax Rev. 31 & n. 176 (July 2006) (describing how favorable results in litigation alter government's settlement strategy). Thus, wholly apart from the *reported* cases affected by the Sixth Circuit's rule, a far greater number of cases, which may never be publicly reported, will be settled differently as a result of that rule.

Third, the Sixth Circuit's decision has even broader implications for corporate finance. Investors, venture capitalists and investment analysts often base their investment decisions and recommendations on an assessment of a company's after-tax rate of return. That assessment necessarily includes both the company's capital financing model and the tax consequences of that model. Doubts about the security and enforceability of a particular capital financing structure may affect a debt rating (thereby increasing the costs of borrowing) or affect an investment recommendation (thereby hurting the company's share price). The uncertainty wrought by the Sixth Circuit's decision calls the security of certain capital financing structures into doubt and, thereby, could affect an assessment of a company's debt and equity instruments.

Certiorari is necessary to correct the potential market distortions wrought by the decision below.

As Justice Thomas speaking for a unanimous Court observed in another tax-related context nearly a decade ago: "[t]he need to avoid litigation and to ensure efficient tax administration counsels in favor of a bright-line standard. . . ." *Arizona Dep't of Revenue v. Blaze Construction Co.*, 526 U.S. 32, 37 (1999). In this case, that principle counsels in favor of *certiorari* where the utilization of important corporate finance tools by the American business community is at stake. Granting *certiorari* will allow this Court to correct the erroneous, muddy rule announced by the Sixth Circuit and, instead, replace it with one that provides clear and proper guidance to American businesses.

II. *CERTIORARI* SHOULD BE GRANTED TO RESOLVE THE RIPE SPLIT AMONG THE FEDERAL APPELLATE COURTS OVER THE PROPER STANDARD OF REVIEW OF ECONOMIC SUBSTANCE DETERMINATIONS.

Dow's petition correctly identifies a split among the federal appellate courts over the proper standard of review of economic substance determinations (Pet. App. 13-19). *Amici* agree with Dow's analysis of this split and briefly offer two additional reasons for why the Court should grant *certiorari* on this issue.

First, the split over the standard of review is an issue of great importance to the nation's business community. In several recent cases, including the decision below, the *de novo* standard has been utilized to upset favorable rulings that taxpaying corporations obtained at the trial level. *See, e.g., TIFD III-E, Inc. v. United States*, 459 F.3d 220, 230-31 (2d Cir. 2006); *Coltec Indus., Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *petition for certiorari filed*, No. 06-659 (Nov. 8, 2006). By contrast, in recent cases when the taxpayers lost in the trial court, plenary review of an "economic substance" or similar determination generally did not benefit

them on appeal—the appellate court found in the Government's favor. *See, e.g., American Elec. Power Co., Inc. v. United States*, 326 F.3d 737, 741 (6th Cir. 2003); *Winn-Dixie Stores, Inc. v. Commissioner*, 254 F.3d 1313, 1315 (11th Cir. 2001); *Keeler v. Commissioner*, 243 F.3d 1212, 1217 (10th Cir. 2001). *But see United Parcel Serv. of Am.* 254 F.3d at 1017. Thus, while the *de novo* standard theoretically might benefit either party, practically it benefits the Government.

Second, this case presents an ideal vehicle for resolving the split on this important issue. The record in this case is well developed. The trial judge made extensive factual findings. Perhaps most importantly, as Judge Ryan's dissenting opinion demonstrates, the standard of review is probably outcome determinative in this case. Analyzed under a clearly erroneous standard, the case would have come out differently. (Pet. App. 21a-34a).

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of *certiorari*.

Respectfully submitted,

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